The Evolving Role of the Director in Corporate Governance

Marshall L. Small
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*By MARSHALL L. SMALL*

I. Developing Trends in Corporate Governance

Corporate governance has, within approximately the past five years, again become a subject of intense national debate, in Congress, the Federal regulatory agencies, the academic community, the organizational--


The SEC in recent years has embarked on a program through enforcement proceedings to secure decrees in appropriate cases calling for restructuring of boards of directors, creation of audit committees, and taking other actions relating to corporate governance. See,
nized bar, public interest groups, and the business community itself. This debate has not been confined to the United States. It has no

3. See, e.g., M. Eisenberg, The Structure of the Corporation (1976), which is based on a series of four articles by Professor Eisenberg: Legal Models of Management Structure in the Modern Corporation, 63 Calif. L. Rev. 375 (1975); Megasubsidiaries, 84 Harv. L. Rev. 1577 (1971); Access to the Corporate Proxy Machinery, 83 Harv. L. Rev. 1489 (1970); The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking, 57 Calif. L. Rev. 1 (1969); Cary, Federalism and Corporate Law, 83 Yale L.J. 663 (1974); Leech & Mundheim, The Outside Director of the Publicly Held Corporation, 31 Bus. Law. 1799 (1976); Weiss & Schwartz, Using Disclosure to Activate the Board of Directors, 41 Law & Contemp. Prob. 63 (1977); Winter, Government and the Corporation (American Enterprise Inst. Studies in Legal Policy 1978) [hereinafter cited as Winter]. In 1976, 80 professors of law at 62 different law schools signed and filed with the Senate Commerce, Science and Transportation Committee a statement expressing their belief that state corporation statutes "no longer adequately serve to guide and regulate the activity of large corporations and their managers," and concluding that "there is a particular urgency at this time for the Congress to consider some form of federal intervention." Hearings on Corporate Rights, supra note 1, at 343.

4. On June 13-14, 1976, a symposium was held at Airlie House, Warrenton, Va. on federal and state roles in establishing standards of conduct for corporate management, under the sponsorship of the Federal Regulation of Securities Committee of the Section of Corporation, Banking and Business Law of the American Bar Association. The proceedings of the symposium are reprinted in 31 Bus. Law. 861 (1976). At its May, 1978, annual meeting, the Council of the American Law Institute authorized the commencement of a project on corporate governance, following a series of discussion groups held under the sponsorship of the ALI-ABA in various portions of the country. In January, 1978, the Council of the Section of Corporation, Banking and Business Law of the American Bar Association approved the publication of a Corporate Director's Guidebook. The Guidebook was initially published as a work product of the Subcommittee on Functions and Responsibilities of Directors of the Committee on Corporate Laws, 32 Bus. Law. 5 (1976), and, following extensive comments, was republished in revised form as approved by the Council of that section, 33 Bus. Law. 1591 (1978) [hereinafter cited as Corporate Director's Guidebook]. The revised Guidebook is also available in separate pamphlet form from the ABA.


doubt been intensified by the disclosures of questionable payments made both overseas and in this country by publicly held corporations, including improper corporate political contributions related to the Watergate investigations; other well-publicized examples of corporate wrongdoing affecting the public health or environment; and by the recent publicity attendant on availability of perquisites to corporate management. However, public debate over the appropriate response to these disclosures may simply mask a more fundamental and pervasive concern as to how the individual can secure more effective control over, and accountability from, the major institutions in American society which affect his or her life.

As a result of this debate it seems clear that the manner in which large publicly held corporations are being governed is in fact changing. Whether the alterations are of style or substance, and whether they are occurring rapidly or with glacial slowness, may be matters of individual perception, varying from observer to observer and from corporation to corporation. These changes, some of which are confirmed by statistically observable trends, may be generally grouped into three

8. See SEC QUESTIONABLE PAYMENTS REPORT, supra note 2, at 34-43 (summarizing the results of public filings by various corporations).
12. In a recent Gallup Poll, 57% of those questioned approved the adoption of a proposed constitutional amendment that would require a national vote on any issue if three percent of all voters in the previous Presidential election signed petitions asking for such a vote. See San Francisco Chronicle, May 15, 1978, at 10, col. 1. The recent adoption in California of the Proposition 13 initiative, which placed a limitation on property taxes, may be another manifestation of this concern.
13. The National Industrial Conference Board, Inc. (now the Conference Board) and
categories.

First, the increased acceptance of the need for nonmanagement directors. Over the past ten years there has been a marked increase in the number of industrial corporations whose boards of directors are composed of a majority of nonmanagement directors, from sixty-three percent in 1967, to seventy-one percent in 1972, and to eighty-three percent in 1977. This trend, which was already well established in the case of financial institutions, reflects a growing awareness of the need for institutionalized objectivity in carrying out the directors' oversight function.

The desirability of securing objectivity in corporate decision-making has long been recognized. Early common-law decisions permitting avoidance of transactions in which directors were interested and later statutes attempting to regulate such transactions have sought to deal with a limited part of the problem by requiring disclosure and approval whenever possible by directors not interested in the transaction. When independent approval has not been obtained, the decisions have typically placed a heavier burden on those who have


14. See 1967 Conference Board Study, supra note 13, at 6; 1972 Conference Board Study, supra note 13, at 2; 1977 Conference Board Study, supra note 13, at 84. The Conference Board's studies treat retired officers as non-management directors. If retired officers are treated as management directors, then the percentages of industrial corporations whose boards are composed of a majority of non-management directors would have been 49% in 1972, and 60% in 1977. See also Corporate Director's Guidebook, supra note 4, Appendix C.


taken action in which they have an interest to demonstrate the fairness of the transaction to the corporation. However, in recent years, the emphasis has shifted from the need to secure independent judgment in discrete transactions to the need for institutional change in the corporate structure, designed to enhance the board environment for disinterested decisionmaking on an on-going basis. As a consequence, it would now seem the exception, rather than the rule, that the need for the presence of nonmanagement directors on the board would have to be urged through shareholder proposal rather than by management itself. Indeed, the Business Roundtable has recently concluded:

The further question is whether in the general or typical case the board should be composed of a majority of outsiders. It is our belief that in most instances—there will be exceptions based on the particular situation of an enterprise—it is desirable that the board be composed of a majority of non-management directors. Both kinds of directors—outside and management—will be subject to the same legal obligations, and will be familiar with the same public and social concerns. However, the fact that a majority of directors have no immediate accountability for short-range financial results assures greater detachment and a better focus on longer-range corporate interests.

We note the strong tendency of U.S. business corporations to move toward a board structure based on a majority of outside directors—and we endorse it.

This viewpoint is also reflected in the Corporate Director's Guidebook prepared by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association, and approved in 1978 in revised form by the Council of the Section. The Guidebook is also being recommended by the American Society of Corporate Secretaries, Inc. to its membership for their consideration, recognizing that particular circumstances may suggest modification of the provisions and policies set forth.

Second, the increased use of board committees. Increased attention is currently being given to the use of committees of directors in order to develop more effective methods of conducting the business of the board, especially in those areas where nonmanagement directors are

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19. For an interesting historical footnote in this respect, see Monaghan, Annual Stockholders' Meetings, 16 Baylor L. Rev. 129 (1964), where general counsel for Standard Oil Co. (New Jersey) noted that this technique was used at Standard's 1964 annual meeting.


expected to contribute to objective decisionmaking. Leading examples of this development have been the audit and compensation committees and, more recently, the nominating committee. Although audit committees of nonmanagement directors had been recommended by the S.E.C. as long ago as 1940, the most dramatic increase in the use of these committees has occurred since the Commission’s more recent pronouncement in 1972. The Commission’s voluntary disclosure program with respect to “sensitive payments,” as described in its 1976 Report to the Senate Banking, Housing and Urban Affairs Committee, has given additional impetus to the use of audit committees of nonmanagement directors. The action of the New York Stock Exchange in requiring listed companies to have audit committees after June 30, 1978, only served to ratify the actions already taken by the overwhelming number of large publicly held corporations. The increase in the number of industrial corporations with audit committees from nineteen percent in 1967 to forty-five percent in 1972, and to ninety-three percent in 1977, confirms this trend. The rise in the use of compensation committees (fifty-seven percent in 1967, seventy-two percent in 1972, and ninety percent in 1977), however, has been less dramatic, since a substantially larger number of industrial corporations have traditionally employed this type of board committee. The nominating committee has been utilized by a smaller number of industrial corporations (almost seven percent in 1972 and twenty-three percent in 1977), but the recent attention received by this committee has already served to promote a substantial increase in its usage. It can also be expected

24. SEC Questionable Payments Report, supra note 2, at 6-13, 67-68.
27. See 1967 Conference Board Study, supra note 13, at 157; 1972 Conference Board Study, supra note 13, at 50; 1977 Conference Board Study, supra note 13, at 85. The functions of a compensation committee are sometimes performed by one or more other committees, such as a stock options committee or pension and retirement benefits committee.
28. See 1972 Conference Board Study, supra note 13, at 51; 1977 Conference Board Study, supra note 13, at 86. No statistics on nominating committees were available in the 1967 Conference Board Study. The 1978 NYSE Study disclosed that 30% of the corporations responding utilized nominating committees. See 1978 NYSE Study, supra note 13, at 4. The sixth annual study of boards of directors by Korn/Ferry International, an executive search firm, disclosed that 71% of the 143 concerns with annual sales over one billion dollars included in its survey either have nominating committees with nonmanagement majorities
that the focus of attention will shift to the specific duties of these three committees as the emphasis changes from the need for creation of the committees to the manner in which they should reasonably be expected to operate.29

Third, the *increased focus on due diligence requirements for individual directors*. Traditionally, the position of directors has been an anomalous one. Having been vested by statute with broad responsibility for "managing" or, more recently, for "overseeing" management of the enterprise,30 and by judicial decisions with a fiduciary role on behalf of the shareholders,31 directors in practice have had limited ability or plan to create them. Wall St. J., Feb. 15, 1979, at 7, col. 1. The *Corporate Director's Guidebook*, supra note 4, strongly recommends the utilization of nominating committees, and the SEC's proxy rules call for disclosure of the use of nominating committees, and whether such committee will consider nominees recommended by stockholders, and if so, the procedure to be followed. *Corporate Governance Rules*, supra note 2, amending 2 Fed. Sec. L. Rep. (CCH) ¶ 24,037, by adding item 6(d)(2) of Schedule 14A. The Business Roundtable Statement also recommends the establishment of a nominating committee. *Business Roundtable Statement*, supra note 6, at 2110. The 1977 Conference Board Study also noted that most corporations also have an executive committee (87% of manufacturing and 88% of nonmanufacturing companies) and many have a finance committee (31% of reporting companies). A lesser number (11% of reporting companies) have a social or public responsibility committee. 1977 Conference Board Report, *supra* note 13, at 85, 86.


30. Many corporation statutes have traditionally referred to directors as having the responsibility to "manage" the corporation. In 1974, § 35 of the Model Business Corporation Act was amended to provide that all corporate power shall be exercised "by or under authority of, and the business and affairs of the corporation shall be managed under the direction of, a board of directors." Delaware's General Corporation law was similarly amended in 1974. *See Del. Code Ann. tit. 8, § 141(a) (Supp. 1977).* Some years previously, Ohio had amended its statute to delete the requirement that the board of directors "shall manage and conduct the business of the corporation," *Ohio Rev. Code Ann.* § 1701.63 (Baldwin 1953) (amended 1955), *II Corporation Manual*, Ohio ¶ 32 (1955), and replaced the statement with the simple clause that all authority of a corporation shall be exercised by its directors, *Ohio Rev. Code Ann.* § 1701.59 (Baldwin 1955) (amended 1963), *II Corporation Manual*, Ohio § 32 (1955). For many years, California's Corporations Code has provided that the corporation is to be managed by or under the authority of the board of directors. *See Cal. Stat. 1947, ch. 1038, at 800 (current version at Cal. Corp. Code § 800 (West 1977)).

31. *See* Fletcher, supra note 16, § 838.
to fulfill either function. Limited advance notice of matters to be considered at board meetings and restricted access to information even for purposes of review have in the past often precluded directors from serving as much more than “rubber stamps” of management. A study of board practices of a number of large, publicly held, U.S. industrial corporations conducted in 1969 by the general counsel of General Electric Company revealed that only about fifty percent of the twenty-five corporations responding ever sent out advance notice to their directors of the agendas for board meetings.\(^{32}\)

As a necessary corollary to the growing recognition of the desirability of having nonmanagement directors, however, it has become increasingly apparent in recent years that directors, particularly nonmanagement directors, will be expected to carry out oversight responsibilities, and take the initiative when it is appropriate to do so. The SEC has begun to stress in various ways the obligations of the nonmanagement director to be vigilant and to initiate action when it is called for,\(^{33}\) so that further emphasis can be expected on a director’s oversight responsibility. Directors may no longer presume that, because they may not be held responsible for the unauthorized, isolated antisocial activities of individual corporate employees of which they are unaware,\(^{34}\) they may therefore be indifferent as to whether their corporation has implemented appropriate loss prevention and legal compliance programs.\(^{35}\)


35. Some courts have in the past imposed upon directors the obligation to be familiar with the manner in which business was conducted by their corporation. See, e.g., National Auto. & Cas. Ins. Co. v. Payne, 261 Cal. App. 2d 403, 67 Cal. Rptr. 784 (1968); Mercer v. Dunscumb, 110 Cal. App. 28, 293 P. 836 (1930); Vujacic v. Southern Commercial Co., 21 Cal. App. 439, 132 P. 80 (1913). See also Frontier Milling & Elev. Co. v. Roy White Cooper. Mercantile Co., 138 P. 825 (Idaho 1914); Barnes v. Eastern & W. Lumber Co., 205 Ore. 553, 287 P.2d 929 (1955). The more sensible rule would be not to impute liability to a director unless the director has received actual notice of improper activity. See Components for Re-
The developing trends noted above offer a constructive means for responding to contemporary concerns with respect to corporate accountability. But they also carry with them at least two risks. First, a confusion of responsibilities may be allowed to develop, thereby placing the director in the untenable position of being required to act as a representative for the “public interest” as well as a delegate of the shareholders of the corporation. Second, as such a representative, a nonmanagement director may become elevated to an unwarranted position of importance in the corporate governance structure, and called upon to solve problems beyond his or her competence to solve.

The purpose of this article is to examine the evolving role of the corporate director in light of the developing trends and risks noted above, and to consider the extent to which increased responsibilities

search, Inc. v. Isolation Prods., Inc., 241 Cal. App. 2d 726, 50 Cal. Rptr. 829 (1966), or has participated in the transaction, see Holland v. American Founders Life Ins. Co., 151 Colo. 69, 376 P.2d 162 (1962), or was sufficiently active in the business that he should be presumed aware of the manner in which the business has been conducted, see Taylor v. Alston, 79 N.M. 643, 447 P.2d 523 (Ct. App. 1968). See also United States Liab. Ins. Co. v. Haidinger-Hayes, Inc., 1 Cal. 3d 586, 595, 463 P.2d 770, 775, 83 Cal. Rptr. 418, 423 (1970). Whatever may have been the purport of prior case law, in the light of developing trends it would be foolhardy of directors not to receive assurances that appropriate loss prevention and legal compliance programs are in place. The enactment of the Foreign Corrupt Practices Act, Pub. L. No. 95-213, §§ 102-103, 91 Stat. 1494, in late 1977, adding § 13(b)(2) to the Securities Exchange Act of 1934 (15 U.S.C.A. § 78m(b)(2)(West Supp. 1978)), may be used to place upon directors the obligation to see that their corporations have adequate accounting systems to provide for accurate recordation of transactions and protect the corporation against loss. The United States Supreme Court decision in United States v. Park, 421 U.S. 658 (1975), also points to a higher duty of awareness for senior officials of large companies. The new proposed federal criminal code provides that a person responsible for supervising particular activities on behalf of an organization who, by his reckless failure to supervise adequately those activities, permits or contributes to the commission of an offense by the organization is criminally liable for the offense, except that if the offense committed by the organization is a felony the person is liable only for a class A misdemeanor. See S. 1437, 95th Cong., 2d Sess. § 403(c) (1978). While directors will be entitled to rely upon reports received with respect to the implementation of necessary programs, see ALI-ABA MODEL BUS. CORP. ACT § 35 (1974), they must at least ask the question periodically as to whether such programs have been implemented.

36. See, e.g., STONE, supra note 10, at 152-83, where the suggestion is made to put public directors on the boards of corporations under certain circumstances. This suggestion was commented upon favorably in Winter, supra note 3, at 57. Conflicts become especially acute for such directors in areas such as protection of the attorney-client privilege and the handling of potential contingent claims against the corporation which have not been asserted, each of which will be discussed more fully infra. See notes 50-51 & accompanying text infra. Furthermore, no matter how carefully selected the board members are, and how conscientiously they perform board duties, their efforts may come to naught if subordinates willfully ignore board directives. For an example of difficulties which a director may encounter in seeking to enforce a legal compliance program, see Wall St. J., Feb. 28, 1979, at 1, col. 6.
can fairly be placed upon directors in a manner that will maintain a realistic balance between imposing minimum standards of performance without detering conscientious individuals from serving as directors. The article will essentially focus on the direction of the large publicly held corporation with widely distributed shareholdings. Where one or a few shareholders control the enterprise, special problems may arise that must be separately considered.37

II. For Whom Should the Director Act?

At its 1978 Annual Meeting the shareholders of Control Data Corporation, a Delaware corporation, were asked to approve the addition of two new provisions to the corporation's certificate of incorporation. One of these provisions (Article Tenth) stated as follows:

TENTH: The Board of Directors of the Corporation, when evaluating any offer of another party to (a) make a tender or exchange offer for any equity security of the Corporation, (b) merge or consolidate the Corporation with another corporation, or (c) purchase or otherwise acquire all or substantially all of the properties and assets of the Corporation, shall, in connection with the exercise of its judgment in determining what is in the best interests of the Corporation and its stockholders, give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation and its subsidiaries and on the communities in which the Corporation and its subsidiaries operate or are located.

The other provision (Article Eleventh) provided for a super-majority vote of shareholders in the event of a business combination with a ten percent shareholder unless certain conditions were satisfied. The proxy statement which proposed these amendments offered the following explanation from management:

The Board is mindful and supportive, as illustrated by its corporate programs, of the growing concept that corporations have a social

37. Under some circumstances, a court may be justified in limiting the rights of voting shares. See, e.g., FLETCHER, supra note 16, at § 2072; cf: Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 47 (1977). However, in the usual case there is little justification for limiting the rights of a substantial shareholder to utilize his shares to control an enterprise so long as he does not obtain unfair advantage by the use of his power. In such cases the controlling shareholder may have the burden placed upon him to demonstrate the fairness of a particular transaction. See cases cited note 18 supra. On the other hand, where the controlling shareholder is not involved in management of the enterprise or does not otherwise deal with the enterprise in a self-interested transaction, there would seem to be little justification for treating such shareholder differently than any other shareholder. Unaccountably, the SEC treats such a shareholder as an interested director when sitting on the board of his enterprise. See Corporate Governance Rules, supra note 2, amending 2 FED. SEC. L. REP. (CCH) ¶ 24,037, by adding Item 6(b)(6) of Schedule 14A.
responsibility to a wide variety of societal segments which have a stake in the continued health of a given corporation. Certainly an important group of stakeholders is the owners of the corporation—its stockholders. They have a right to expect a reasonable return on their investment and current, candid information on the health and future plans of the enterprise. Many other groups hold a stake in the corporation. Employees not only have a financial tie to the corporation, but in many cases have invested a part of their lives in it. In addition, vendors and suppliers, customers, and communities are reliant on the corporation and deserve appropriate consideration. It is in the spirit of social responsibility and justice that Articles Tenth and Eleventh are proposed.

It is of more than passing interest that at a time when the structure of corporate governance is the subject of critical examination, an object of that scrutiny should seek shareholder approval of the proposition that the corporation serves a broader constituency than its shareholders. The cynical spectator might observe that the proposition was being put forward in an effort to give incumbent management an additional basis for legitimizing opposition to unwanted tender offers. The proposition was narrowly approved, but it was apparently opposed by institutional investors who saw it was a potential depressant on the market price of their shares. Whatever may have been the true motivations of the sponsors and the opponents of the proposition, the controversy that it engendered underscores the need to agree upon the constituency to be served by directors and managers when addressing concerns as to corporate governance.

This need is increased by contemporary proposals that would place on corporate boards representatives of different identified constituencies such as employees or consumers, or public interest directors who would have an obligation to represent and report as appropriate to the general public. The SEC itself indicated in its proposed rules respecting corporate governance that its staff was addressing the means by which corporations could best account to shareholders and the public.

The actions of the large publicly held corporation affect various recognizable groups in our society—shareholders, employees, competitors, consumers, and suppliers. Such actions also have an impact on less well-defined groups in society, such as those members of the public

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40. See STONE, supra note 10, at 152-83; Winter, supra note 3, at 57.
41. See Proposed Governance Rules, supra note 2, ¶ 81,645, at 80,576. Perhaps it can be assumed that the SEC was referring to the investing public.
who may be directly affected by the corporation's treatment of environmental concerns, or the public at large, which may be indirectly affected by a corporation's lack of an energy conservation program, an anti-inflation program, or by the corrosive effect of a corporation's disregard of such laws as those prohibiting bribery of government officials. The method for assuring that the corporation satisfies its obligations to each group and the determination as to whether those obligations can best be satisfied through the mechanism of corporate governance or by some other means must be separately considered in the light of the objectives sought to be accomplished. It would, therefore, be useful to examine separately these objectives as to each of the foregoing groups.

A. Objectives of Shareholders

That private enterprise is the method by which goods and services are most efficiently supplied in our society is a commonly accepted tenet. Correlatively, encouragement of private capital formation is essential to the continued viability of the private enterprise system. Concerns have been voiced as to whether existing governmental policies, particularly in the areas of tax policy and securities regulation, are conducive to private capital formation and investment. There should be equal public concern that publicly owned corporations, which are the recipients of capital, be governed in a manner that will encourage potential investors to contribute capital to these enterprises as needed. Such governance must be based, in the final analysis, on the successful efforts of the managers responsible for the operation of the enterprises; but it also requires that existing and future shareholders be assured that at a minimum certain areas be subject to oversight by persons who can supply objective and informed judgment to the decisionmaking process.

First, competent managers must be employed to operate the enterprise, and programs for advancement and management succession must be developed to assure enterprise continuity. Senior management must be fairly compensated at a level that will attract and retain a competent staff, and at the same time not result in unfair advantage being


taken of the corporation, such as through excessive executive perquisites.

Second, the enterprise's financial statements, and other public disclosure documents, must accurately reflect its financial health and the success of its operations. Accurate financial statements and other public-disclosure documents not only assist in measuring competence of management vis-a-vis its competition, but give assurance to investors, warn of potential dangers, and serve as a basis for measuring management incentive compensation.

Third, adequate controls must be in place to protect against loss of assets and assure compliance with law. Inquiry is also necessary as to whether the enterprise is operating in a socially desirable manner, even if its conduct is not yet legally sanctionable, in order to enhance the likelihood of its long-term economic success.

Fourth, long-range planning must be carried out to anticipate changes in demand for the enterprise's products, the development and introduction of new products, the need for additional facilities as well as the additional funds to supply the same, and to otherwise respond to potential problems. These general objectives can be accomplished within traditional concepts of corporate governance, namely that corporations are to be managed for the benefit of their shareholders and that those responsible for management act as stewards for the shareholders.

B. Objectives of Employees

Even acknowledging the increasing use of automation, a stable

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44. Such controls should include not only internal audit functions, asset protection programs through employee secrecy agreements, and patent and insurance programs, but also a review of investment policies for short-term investments where the corporation has material amounts of cash to be so invested.

45. Consideration of the social responsibility of corporations is not a new subject but has been considered extensively in recent years. See, e.g., Blumberg, Reflections on Proposals For Corporate Reform Through Change in the Composition of the Board of Directors, 53 B.U.L. Rev. 547 (1973); Blumberg, Selected Materials On Corporate Social Responsibilities, 27 Bus. Law. 1275 (1972); Ruder, Public Obligations of Private Corporations, 114 U. Pa. L. Rev. 209 (1965). However, the current focus on evolving directors' responsibilities makes necessary a reexamination of the question in any discussion of the subject.

46. Potentially more dramatic examples of such long-range concerns could include the impact of the energy crisis on oil companies, the automobile industry and public utilities, and the health impact of governmental findings with respect to presence of carcinogens in consumer products. Less dramatic but more frequently recurring examples would include the on-going process of evaluating anticipated profitability of existing products and segments of business enterprises and proposed future products in connection with preparation of corporate budgets.
and well-motivated work force remains essential to the success of any business enterprise. In order to achieve this objective, the enterprise must consider such factors as maintaining a safe working environment, rational and nondiscriminatory practices in hiring, promotion, and retention, fair compensation, adequately funded retirement benefits, and the continuity of the enterprise as an employment resource. Obviously, these factors are also of concern to shareholders in ensuring the success of the enterprise, but the corporate governance structure that provides for disinterested oversight in responding to shareholder concerns will not necessarily meet the needs of employees. Traditionally, the advancement of employee objectives has come from outside the corporation through governmental regulation and collective bargaining.47 Those enterprises that have achieved a stable and well-motivated work force without the need of governmental sanction or collective bargaining have generally done so without the need for including employee representation, as such, in the corporate governance structure. While we have witnessed a recent attempt by employee representatives to use the corporate governance structure as an indirect means of achieving their objective,48 there does not yet appear to be any pressing desire for employee representatives to serve as part of the corporate governance structure of domestic corporations. Any attempt to do so would inject into the oversight structure an element of conflict of interest, contrary to the objective of avoiding self-interest in the decisionmaking process.49

47. Examples of such regulations would include the National Labor Relations Act, OSHA, ERISA and the Fair Labor Standards Act. For a review of development of the concept of worker participation in management, see Worker Participation, Conference Board Report No. 594 (1973).

48. The tactics of the Amalgamated Clothing & Textile Workers Union in connection with its dispute with J.P. Stevens & Co. are an example. See N.Y. Times, March 8, 1978, § D (Business), at 1, col. 3; id., March 17, 1978, § D, at 1, col. 4.

49. Even the recent British White Paper on Industrial Democracy recognizes the need of employee representatives on a supervisory board to act subject to the same legal duties and responsibilities as any other director. See INDUSTRIAL DEMOCRACY, supra note 7, ¶ 25, where it was stated: "All directors on the top board, however appointed, will share the same legal duties and responsibilities. As under the present law all directors will be required to act on their own authority and responsibility. Company law prohibits the mandating of a director to vote in a particular way. The Government believes, as did the Bullock Committee, that there should be no departure from this principle and that there should be no question of employee or shareholder directors being mandated to vote in accordance with the instructions of those by whom they are appointed. Nevertheless it is essential that they keep in touch with the opinion of those they represent. Employee directors in particular should be in close touch with the employees and the trade unions. This will be important if they are to be able to reflect the views of the workforce and to provide an effective channel of communication to them. It will be for those in each company to devise arrange-
C. Objectives of Customers and Competitors

Both the purchasers of an enterprise's products or services and those with whom the enterprise competes are concerned that the products or services being distributed are as represented and, if not affirmatively beneficial, at least not harmful to the recipients. Furthermore, both customers and competitors are concerned that the enterprise not engage in anticompetitive practices. These objectives have traditionally been accomplished through corporate response to both the free action of the marketplace and governmental sanction, rather than directly through the structure of corporate governance.

While developing trends in corporate governance, as discussed above, may reinforce governmental regulation in this area, it would not seem appropriate to modify the operational structure of the corporation to provide for special consideration of these groups as a part thereof, not only because of antitrust considerations but also because to do so would, as in the case of employee representation, insert an undesirable element of conflict of interest into the governance structure.

D. Objectives of the General Public

Members of the general public may be directly affected by activities of business enterprises, for example, through air or water pollution, and may be indirectly affected by other activities, such as the setting of good or bad examples as to resource utilization or the support or destruction of government as a result of bribery of public officials. General public objectives have traditionally been accomplished through external governmental sanction. While the inclusion of a "public interest" representative in the corporate governance structure may be of superficial attraction to some, such an approach is apt to prove counterproductive for a number of reasons to be discussed, and may result in an unacceptable confusion of responsibilities for those upon whom the burden of governance will ultimately fall.

E. Congruence and Conflict of Objectives

In considering the concerns of shareholders, employees, customers, competitors, and the public, it must be recognized that while there may be common objectives in many cases, these groups will frequently
make inconsistent demands on the enterprise. For example, the claim of employees for higher wages may conflict with the desire of consumers for lower prices for the corporation's products and of shareholders for a profitable enterprise. The desire of employees to keep a plant operating may clash with the public desires to curb environmental pollution, and the shareholders' interest in eliminating a losing operation. The interests of injured parties and potential investors in the enterprise in full disclosure may conflict with the interest existing shareholders have in minimizing losses to the enterprise by not disclosing unasserted contingent liabilities.  

In resolving these conflicts, it would appear that those responsible for the decisionmaking must inevitably be guided by the long-term interests of the owners of the enterprise in its economic survival and success. This conclusion does not require, however, that the decision-makers be insensitive to the interests of the other constituencies the corporation serves. Indeed, in the usual case the long-term interests of the enterprise will be consistent with the interest of these other constituencies. In those instances where there does appear to be a potential conflict between the long-term interests of the existing shareholder body and one of these other parties, recognizing that those responsible for corporate governance are ultimately charged with responsibility to the shareholders offers a useful frame of reference in the decision-making process.  

It must also be recognized that corporate governance offers only limited answers to the larger question as to how corporate behavior should be influenced. Corporations are subject to a multitude of laws

50. The examples furnished in the preceding discussion are no doubt over-simplified. In any given case resolution of conflicts may involve weighing a number of factors. For example, the problem of steel pricing involves not only the profitability of domestic steel companies but also the interests of their employees, domestic purchasers of steel, the consuming public who must pay higher prices for products using steel, relations with foreign nations and the necessity of encouraging free trade, and the importance to the national interest of maintaining the health of a basic industry necessary for national security. These various concerns become particularly acute in the case of a subsidized industry such as shipping.  

51. Two concrete examples of situations where such a frame of reference is required are (1) the rights and obligations of a corporation with respect to assertion or waiver of the attorney-client privilege, cf. Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977) (en banc) (right of directors to maintain the confidentiality of an investigative report); Garner v. Wolfinbarger, 430 F.2d 1093 (10th Cir. 1970), cert. denied, 401 U.S. 974 (1971) (right of shareholders in derivative actions); SEC v. Canadian Javelin, Ltd., 451 F. Supp. 594 (D.D.C. 1978) (obligation of an independent compliance counsel appointed to monitor corporation); and (2) the obligations of directors with respect to disclosure of unasserted contingent liabilities, see Statement of Financial Accounting Standards No. 5 (Accounting for Contingencies), 3 AICPA PROFESSIONAL STANDARDS (CCH) ¶ 4311 (March 1975).
that shape their behavior. Furthermore, public-interest issues arise whose resolution will have no clear material impact on the economic well-being of the enterprise but will cause shareholder disagreement as to the position to be taken by the corporation. For example, there may be disagreement among shareholders as to whether the enterprise should manufacture a certain product (such as napalm), do business in a particular area (such as South Africa), or construct a particular type of facility (such as a nuclear reactor). To what extent should the corporation itself attempt to resolve these conflicts through its corporate governance structure and to what extent should they be resolved by others? This decision may be shaped by governmental concerns of foreign policy, national defense, energy policy, or some other overriding public concern. It must be recognized that in many cases there will be a compelling need to establish a process for orderly decisionmaking that may not include the corporate governance structure as the institution best able to carry out the process.\(^2\) The answer to this last question may become more vexing in view of the new-found freedom (and perhaps obligation) recently given to business enterprises by the United States Supreme Court to express themselves on public issues not directly relevant to their operations.\(^3\)

### III. What Responsibilities Can Directors Reasonably be Expected to Assume?

As the role of the director, and, in particular, the nonmanagement director, increases in significance, one must consider carefully what may realistically be expected of a director. In the past it has been suggested that nonmanagement directors be furnished with separate staff and undertake their own factual investigations to assist them in decision-making.\(^4\) This approach has been followed recently in handling discrete problems such as the use of audit committees to conduct investigations of "sensitive payments."\(^5\) However, it has not met with approval as a general technique for corporate governance, since it not only creates unnecessary tensions between management and nonmanagement directors, but is a waste of resources when used to create what

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\(^4\) See Goldberg, *Debate on Outside Directors*, N.Y. Times, Oct. 29, 1972, § 3, at 1, col. 3.

\(^5\) This approach has been encouraged by the Securities and Exchange Commission. See SEC *QUESTIONABLE PAYMENTS REPORT*, *supra* note 2, at 67-68.
is in effect a "shadow" management to verify management actions.\(^5\)

The balance has been more realistically struck in favor of allowing directors to rely, in the usual case, on reports of management and others, and to require independent verification only in unusual cases where the facts suggest that it would be appropriate to do so.\(^5\) The developing case law to date supports this result by placing a lesser duty of investigation on nonmanagement directors unless they are in possession of facts sufficient to place them on inquiry notice.\(^5\) This distinction between management and nonmanagement directors has also been recognized in the proposed Federal Securities Code.\(^5\)

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\(^{56}\) See M. Eisenberg, The Structure of the Corporation 155 (1976); Address by Roger M. Blough, New York City Bar Association Meeting (Feb. 7, 1973), printed in 45 N.Y. St. B.J. 467 (1973) (detailed rebuttal to Arthur Goldberg proposals).

\(^{57}\) See ALI-ABA Model Bus. Corp. Act § 35 (1974). See also Corporate Directors Guidebook, supra note 4. Corporation statutes impose specific responsibilities on directors, such as the authorization of amendments to the corporate charter and by-laws, the issuance of equity securities, and approval of corporate combinations and payment of dividends. In each case, the directors will normally rely on reports of others as a basis for taking action.


\(^{59}\) See ALI FED. SEC. CODE § 1704(g) (Proposed Official Draft, 1978), which states: "[Standard of reasonableness] in determining what constitutes reasonable investigation or care and reasonable ground for belief under section 1704(f)(3), the standard of reasonableness is that required of a prudent man under the circumstances in the conduct of his own affairs. Relevant circumstances include, with respect to a defendant other than the registrant, (1) the type of registrant, (2) the type of defendant, (3) the office held when the defendant is an officer, (4) the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, (5) reasonable reliance on officers, employees, and other whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular defendant with respect to the registrant and the filing), (6) when the defendant is an underwriter, the type of underwriting arrangement, the role of the particular defendant as an underwriter, and the accessibility to information with respect to the registrant, and (7) whether, with respect to a fact or docu-
It would now be appropriate to return to the four broad objectives of the corporation's shareholders, noted above, to assess what may realistically be expected of a director in responding to those concerns.

A. Employment and Compensation of Managers and Directors

To expect that directors will be involved in the selection of senior-level managers is reasonable. In many corporations directors will first become acquainted with the identity of senior executives through reports made to the Board. They may also become acquainted with such managers when approving compensation rates for senior executives, which will entail some monitoring of performance. These functions will normally be performed through a board committee, such as a wage and compensation committee. To the extent that the corporation is operating successfully and vacancies are filled by promotions from within, the directors will have little occasion to question the recommendations of management as to how vacancies are to be filled. However, they will want to be informed as to the experience and qualifications of nominees for management vacancies and they will want to know that there is a definite program designed to ensure the presence of capable managers at various levels in the organization.60

When the chief executive officer's position is to be filled by an appointment from outside the corporation, the directors must take a more active role in recruitment and selection, such as through a nominating committee.61 A nominating committee of directors can also effectively carry out other important activities including recommending the selection of nonmanagement directors, the appointment of directors to board committees, and the formulation of policies for retirement of directors. To the extent that the nominating committee is composed of unaffiliated nonmanagement directors, there will be an opportunity to promote recognition of board decisions as objectively reached in those cases where objectivity is particularly essential.62 The directors should

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60. Some corporations also make plans for disaster contingencies by having tentative determinations made as to which officers will assume posts of responsibility in the case of unexpected death or disability of key senior officers.

61. See Corporate Director's Guidebook, supra note 4.

62. See Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir.), cert. granted, 47 U.S.L.W. 3221 (1978) (No. 77-1724). The acceptance of board decisions may be particularly useful in determining whether to take action against officers or employees of the corporation based on alleged misfeasance or nonfeasance. The presence of objective decision making in such circumstances may be determinative as to whether a shareholder derivative action is permitted to proceed. See Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).
also be capable of monitoring the appropriate levels and types of compen-
sation for senior managers through a wage and compensation com-
mittee, through periodic consultation with independent management
consulting firms retained by the committee.

The compensation committee is also an appropriate vehicle for es-
tablishing policies as to utilization of corporate facilities (such as
planes, hunting lodges or automobiles) for personal purposes and the
necessity, if any, for securing reimbursement for such use. It would
seem desirable for reports on the usage of such facilities to be furnished
to the committee through some audit procedure to ensure that company
facilities are being utilized in an authorized manner.

A particularly sensitive problem is review of the directors’ own
compensation. Here again it would appear appropriate to secure the
assistance of an independent management consultant, although it
might be more appropriate to have management select a consultant dif-
f erent from the one employed by the committee for its own purposes. 63

Indemnification of officers for the expenses of litigation may be
handled in the same manner as compensation, subject to statutory con-
straints. However, it would appear appropriate (and often statutes re-
quire) 64 that such indemnification of directors be subject to shareholder
approval or other independent review unless disinterested directors are
available to afford objective approval.

In summary, directors can and should perform an effective over-
sight function in the selection and compensation of senior managers, so
long as it is understood that they are not to be held personally responsi-
ble for the mistakes of managers they select unless those selected are
obviously unqualified by their past experience for their positions.

B. Accuracy of Financial Statements and Other Public Disclosure
Documents

Directors cannot be expected to verify personally the accuracy of
the details in the corporation’s financial statements or other pub-
lic-disclosure documents. They can be expected, however, to insist that

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63. The increased availability of information on levels of directors’ compensation
would also be helpful in this respect as a means for measuring fairness of compensation
levels. Under recent SEC revisions in its regulations, disclosure is required as to compensa-
1978), [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,765, at 81,084 (Regulation S-K,
Item 4(c)).

64. See, e.g., ALI-ABA MODEL BUS. CORP. ACT § 5 (1969); CAL. CORP. CODE § 317
certain minimum procedures be followed to reduce the risk of inaccurate disclosure documents.

First, directors can and should insist that all published financial statements be carefully reviewed (preferably with the assistance of the corporation's independent certified public accountants) prior to publication and that all other public disclosure documents be reviewed and approved by counsel prior to release. Second, directors should insist on receiving, at reasonable intervals, copies of the corporation's interim financial reports. Although directors should not be expected to analyze such financial statements in detail, they should peruse or arrange for some committee of directors, such as the audit committee, to peruse such material for obvious adverse trends for which they should seek explanation from management.

Finally, directors should insist on the creation and effective operation of an audit committee to perform certain specified functions with respect to the accuracy of the corporation's financial statements. These functions, which should be clearly set forth in the committee's operating charter, should include meeting with the corporation's independent auditors to review their proposed program for the annual audit and reviewing their audit report, including any problems the accountants believe have developed during the course of the audit. These reviews should also cover the independent accounting firm's assessment of the corporation's accounting personnel and accounting systems (including any internal audit function) and their cooperation with the independent accountants. Such meetings should as a matter of practice include regularly scheduled meetings outside the presence of management representatives. The audit committee should also meet separately with management to review their views as to the quality of service received from the outside accountants and the cost of their services, so as to be in a position to recommend their retention or replacement. The nature of functions to be performed by the audit committee suggests that it should most appropriately be composed of nonmanagement directors.65

65. This is the generally shared view. See Corporate Director's Guidebook, supra note 4; Business Roundtable Statement, supra note 6; New York Stock Exchange Company Manual A-29; 2 NYSE Guide (CCH) ¶ 2495H (1977). This is also the view generally adopted by the major accounting firms who have issued brochures on the subject of audit committees, although some firms refer only to a majority of nonmanagement directors. See Arthur Anderson & Co., The Audit Committee of the Board of Directors 4 (1978); Arthur Young & Co., Shaping an Effective Audit Committee 11 (1974); The Coopers & Lybrand Audit Committee Guide 11 (2d ed.); Corporate Audit Committees, Ernst & Ernst 35 (1977); Audit Committees, Haskins & Sells 13 (1974); Peat Marwick, Mitchell & Co., The Audit Committee 5 (1977); Price Waterhouse & Co., The Audit Committee, The Board of Directors and the Independent Accountant 3 (1976); Touche Ross & Co., Corporate Audit Committees 6 (1970).
A considerable body of precedent has been developing in recent years as to the functions an audit committee should perform. It may be desirable to impose additional responsibilities upon the audit committee from time to time, such as the responsibility to obtain assurance that adequate internal auditing controls have been provided to satisfy the requirements of the Foreign Corrupt Practices Act. In recent years, audit committees have been utilized as vehicles to carry out investigations with respect to corporate misconduct, both as part of voluntary compliance programs and pursuant to SEC enforcement proceedings. It is important to emphasize in this connection two points: first, there is no necessary expertise possessed by audit committee members that makes them more able than other directors to carry out factual investigations, and second, inevitably the audit committee must rely on others to exhume and evaluate the facts, because it cannot be expected itself to conduct the personal interviews and review the documents incident to a careful investigation. In assessing the responsibilities of directors who serve on audit committees, expectations as to what such a committee can accomplish must be reasonable. One can expect the committee to have clear, written guidelines pertaining to its function, and the committee may be expected to act in an objective manner in carrying out its responsibilities. However, it must be recognized that there are inherent limitations on the effectiveness of the audit committee as a device for avoiding corporate wrongdoing.

C. Maintenance of Controls Against Loss of Assets and Assurance of Compliance with Law

Although directors may be unable to verify personally that adequate controls are in place to protect the corporation against loss of assets or insure compliance with applicable laws, directors do have certain minimal obligations in this area.

First, they must satisfy themselves periodically, through reports

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66. See note 29 supra.
67. See note 35 supra. See also notes 70-102 & accompanying text infra, as to maintenance of controls against loss of assets and assurance of compliance with the law. As a result of the disclosures now required by item 8(f) of Schedule 14A of the SEC's proxy rules, the Audit Committee should also give some form of advance approval to the rendition of non-audit services by the independent auditors.
from management, that the corporation has in place certain types of identified programs for asset protection. Such reports should cover the following. The board should require information on the firm’s insurance practices, including both insurance coverage and its relevancy to the corporation’s operations, and the extent to which the corporation self-insures against risks through deductibles or otherwise. Programs should be in place for protection of patentable inventions, trade secrets, copyrights, and trademarks, including employee secrecy covenants and agreements respecting handling of unsolicited ideas proffered to the corporation to the extent relevant to the corporation’s business. Procedures should be implemented for investment of short-term corporate funds to the extent these are material to the corporation’s operations.

Finally, there must be clear policies on disclosing potential conflicts of interest. In view of the recent passage of the Foreign Corrupt Practices Act, it is now essential that directors also receive assurances that adequate internal accounting and auditing controls have been provided. Obtaining such assurances annually from the corporation’s independent certified public accountants should be a responsibility assigned to the audit committee. By detailing the foregoing areas of inquiry, it is not intended to suggest that there are any particular forms of asset pro-

69. For an example of the problems which may arise from investment in money market instruments, the litigation spawned by the collapse of the Penn Central R.R. and the resulting defaults on its outstanding commercial paper might be noted. See Alton Box Board Co. v. Goldman Sachs & Co., 560 F.2d 916 (8th Cir. 1977), and cases cited at 918 n.1.

70. The directors will of necessity be required to rely upon the advice of others—such as the corporation’s outside auditors—as to whether adequate internal audit controls have been provided, but at least responsibility should be faced for raising the issue periodically. The legislative history of the Federal Corrupt Practices Act, Pub. L. No. 95-213, §§ 102-103, 91 Stat. 1494 (amending 15 U.S.C. § 78m(b)), makes clear that there is not an automatic requirement imposed on each corporation subject to the Act to develop an internal audit staff, since consideration must also be given to balancing the need for such a step against the cost of implementing an internal audit program: “The establishment and maintenance of a system of internal control and accurate books and records are fundamental responsibilities of management. The expected benefits to be derived from the conscientious discharge of these responsibilities are of basic importance to investors and the maintenance of the integrity of our capital market system. The committee recognizes, however, that management must exercise judgment in determining the steps to be taken, and the cost incurred, in giving assurance that the objectives expressed will be achieved. Here, standards of reasonableness must apply. In this regard, the term ‘accurately’ does not mean exact precision as measured by some abstract principle. Rather it means that an issuer’s records should reflect transactions in conformity with generally accepted accounting principles or other applicable criteria. While management should observe every reasonable prudence in satisfying the objectives called for in new paragraph (2) of section 13(b), the committee recognizes that management must necessarily estimate and evaluate the cost/benefit relationships of the steps to be taken in fulfillment of its responsibilities under this paragraph. The accounting profession will be expected to use their professional judgment in evaluating the systems maintained by issuers. The size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management
tection programs that should be adopted, since the appropriate coverage will vary from corporation to corporation. Rather, the author suggests that the directors at least periodically consider the matter and, after review of management’s reports, act as reasonable businessmen in determining whether the reports disclose any material gaps in coverage.

Second, the directors must satisfy themselves periodically through reports that the corporation has identified those laws applicable to its operations, and that it has put in place appropriate programs to inform its employees on an on-going basis as to the existence of such laws and the need to comply with them. Some assurances should be obtained that compliance is in fact occurring. Implementation of such a program requires a recognition at both board and management levels that there must be available adequate legal personnel, either through an inside legal staff or outside law firms. Because of personnel turnovers and fading memories the educational program must be a continuing process.

Finally, a commitment is required from both the board and senior management that deviations from the policy of compliance with the law will not be tolerated. Such a program will protect the interests of the shareholders by avoiding governmental and private litigation against the corporation and consequent depletion of not only the corporate treasury through fines and damage awards, but the corporation’s reputation in the community as well. Such a program also will meet the criticism that large, widely-held public corporations do not obey the laws governing their operations.71

Having noted the obligations of the directors to assure themselves that corporate legal compliance programs are in place, it is also essential to recognize certain problems that will inevitably arise in connection with any such program.

1. Limitations on a Director’s Discretion when the Loyalty of a Proposed Course of Conduct is Subject to Dispute

Neither administrative agencies nor legislatures are infallible. The casebooks are replete with decisions successfully challenging the validity of administrative rules and orders on various grounds. For example, failure to provide prior notice and opportunity for public hearing may in an appropriate case render administrative action nugatory.72


71. See, e.g., STONE, supra note 10.

72. See, e.g., American Bancorpation, Inc. v. Board of Governors, 509 F.2d 29 (8th Cir.
State legislative action may be determined to be precluded by federal preemption or otherwise found to be unconstitutional. Even where a statute or regulation is determined to be enforceable, its application to a particular set of facts may be unclear, or changing judicial interpretations of the statute may permit conduct once thought to be proscribed.

The obligation of the director to see that his corporation obeys the law should not, therefore, preclude him from authorizing a challenge to a statute or regulation when there is reason to believe it is invalid. Furthermore, the director is entitled to assert that a course of conduct is lawful when counsel advises that there is no controlling precedent and a possibility exists that the proposed course of conduct will be determined not to be legally permissible. However, the occasions when such a legal challenge is deemed necessary will be infrequent, and before providing such authorization, the director will wish to weigh carefully the possible consequences to the corporation and to the Board itself that may flow from responses by either interested Government agencies, third persons claiming to have been harmed by the course of conduct, or shareholders claiming injury to the corporation by the authorized action. Before authorizing conduct which may be subject to legal challenge, the director should obtain satisfactory responses to several areas of inquiry.

a. Basis for Conclusion that Proposed Conduct is Lawful

Counsel may not be able or willing to give an unqualified opinion


74. For example, in assessing the legality of a contemplated business combination under § 7 of the Clayton Act (15 U.S.C. § 18 (1976)), a determination must be made as to whether the transaction will tend to reduce competition in a relevant line of commerce, thus requiring an identification of relevant competition and market share. See A. Stickels, FEDERAL CONTROL OF BUSINESS § 92 (1972). In determining whether a particular pricing program is lawful under the Robinson-Patman Act, complex cost justification analysis may be required. See, e.g., H. Shniderman, PRICE DISCRIMINATION IN PERSPECTIVE § 95 (1977). The task of compliance with such a statute may also be complicated by lack of enthusiasm by the government itself for enforcement of the statute and by actions of more aggressive competitors. See [1977] ANTITRUST & TRADE REG. REP. (BNA), No. 798 (noting the critical attitude of the Department of Justice).

that the proposed conduct is lawful, but unless there is a reasonable
basis for concluding that the conduct is legally defensible, the conduct
should not be authorized. The director should understand that even
the unqualified advice of counsel that conduct is lawful will not neces-
sarily immunize either the director or the corporation from legal sanc-
tions. The courts have indicated that advice of counsel is but one factor
to be considered in determining whether action was taken in good faith
and with due care. Reliance on advice of counsel will not be consid-
ered as a defense in any event if specific intent is not a required element
of the criminal offense or civil cause of action in question, although
it may be considered in mitigation in a criminal proceeding or as a
basis for limiting civil damages.

b. Consequences to the Public Resulting from the Proposed Conduct

The director should consider the strength of the public policy un-
derlying a proscription on proposed conduct, and the type of harm, if

76. There have been suggestions that before proceeding, the directors should receive an
opinion that the proposed action is more likely than not to be held lawful. See Hawes &
Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62
VA. L. REV. 1, 34 (1976) [hereinafter cited as Hawes & Sherrard]. An attorney may under-
standably be reluctant to quantify his advice in precise mathematical terms so as to be able
to deliver an opinion that the "odds" favor legality of the action. It would appear more
appropriate to require that the attorney be prepared to indicate that there is reasonable basis
for concluding that the proposed action is lawful. This would seem to be an acceptable basis
for proceeding in the tax cases. See AMERICAN BAR ASSOCIATION, OPINIONS ON PROFES-
SIONAL ETHICS, Op. No. 314, 688, 691 (1967); Rowen, When May a Lawyer Advise a Client
That He May Take a Position on His Tax Return?, 29 TAX LAW. 237, 239-40, 258 (1976). See
also CALIFORNIA STATE BAR RULES OF PROFESSIONAL CONDUCT, RULE 7-101, which pro-
vides that a member of the State Bar shall not advise the violation of any law, rule or ruling
of a tribunal unless he believes in good faith that such law, rule or ruling is invalid, and that
a member of the State Bar may take appropriate steps in good faith to test the validity of any
law, rule or ruling of a tribunal.

77. See Hawes & Sherrard, supra note 76, at 148.

78. See Williamson v. United States, 207 U.S. 425 (1908); United States v. Wood, 446
F.2d 505 (9th Cir. 1971); United States v. Gulf Oil Corp., 408 F. Supp. 450, 463 (W.D. Pa.

79. See Haynes v. Logan Furniture Mart, Inc., 503 F.2d 1161 (7th Cir. 1974); McGlynn

80. See Hawes & Sherrard, supra note 76, at 9 n.20, citing cases permitting reliance on
advice of counsel to be used in mitigation of a criminal contempt charge, but not as an
absolute defense. Where counsel is faced with negotiating a consent decree requiring the
client to act in accordance with law, consideration might be given to inserting a provision
that states that challenging a statute, regulation or order on advice of counsel when there is a
reasonable basis for the challenge will not be deemed to constitute contempt of the decree.

U.S. 931 (1973); Hawes & Sherrard, supra note 76, at 11.
any, likely to be caused to others through a challenge to a legal prohibition on proposed activities. 82

c. Consequences to the Corporation if the Proposed Conduct is Determined to be Unlawful

The director should also take into account the type of sanctions that may be imposed upon the corporation, such as loss of licenses, fines or judgments for damages. The director must weigh the possible material effect on the corporation’s business of embarking or failing to embark on the proposed course of conduct. Is there a sufficiently attractive corporate opportunity that, on balance, it is in the best interests of the shareholders to proceed?

d. Alternatives Available for Establishing Legality of Proposed Conduct

The director should inquire whether there are practical alternatives available to test the legality of a proposed conduct short of actually engaging in the conduct. Particular administrative procedures may permit advance rulings on the legal consequences of proposed actions. 83 The corporation might seek declaratory relief as to the legal consequences of its proposed conduct rather than run the risk of engaging in the conduct and later be unable to sustain its legality. 84 However, circumstances may not make the latter a feasible alternative, and, in any event, the directors may not wish to precipitate litigation, especially when they are reasonably comfortable with the propriety of their position and when the consequences to the corporation will not be dire if the directors are ultimately proved to be in error.

In summary, directors, without being branded as scofflaws, should be entitled to exercise their sound business judgment in authorizing a proposed course of action. In exercising this judgment, the directors will, of course, have to consider advice of counsel and weigh the poten-

82. For example, the director will presumably be more cautious in challenging a prescription on distribution of potentially harmful consumer products unless he is satisfied that the products in question are in fact not harmful to the public. Consider, in this connection, the recent controversy over banning saccharin.

83. Advance requests for SEC no-action letters on the applicability of federal securities laws and for Internal Revenue Service rulings on the tax consequences of proposed transactions are two often-used examples of this technique. Of course, the SEC no-action letter will not protect against claims of third parties and the IRS ruling is not necessarily binding on the government in subsequent proceedings.

84. This technique was utilized in First Nat’l Bank v. Bellotti, 432 U.S. 904 (1978), in challenging Massachusetts’ limitations on corporate spending for political purposes. However, the courts may not be sympathetic to suits for declaratory relief challenging the constitutionality of legislation where there is no real threat of enforcement. See Poe v. Ullman, 367 U.S. 497 (1961).
tial benefits to the corporation resulting from the action against any potential detriment to the corporation or third parties should the proposed action ultimately be determined by a court to be unlawful.

If the directors in the exercise of their sound business judgment authorize conduct that is ultimately determined to have been unlawful, the issue then arises as to the extent the directors may be held personally liable, either in a direct suit by a governmental entity or third persons claiming damage, or in a shareholders' derivative suit. A subsidiary question is the extent to which the directors are entitled to indemnification should they be held liable.

When the directors personally authorize conduct that is later determined to be unlawful, under existing decisions there is a strong likelihood that they may be held responsible in case of suits by the Government or third parties unless their reliance on advice of counsel affords them a defense. On the other hand, the decisions do acknowledge that when directors act in what they honestly and reasonably believe to be the best interests of the corporation, the so-called "business judgment rule" should protect them from personal liability in a derivative action even though it is ultimately determined that they acted in violation of law. Furthermore, unless there is proof of harm to the

85. See cases cited notes 35, 77-78, 79 supra. See also note 89 infra. Should the directors adopt a policy of consciously avoiding involvement in decisions where advice of counsel is not a defense, under the developing concepts of directors' responsibilities they run the risk of being charged with failure to supervise management's actions.

86. See Parish v. Maryland & Va. Milk Producers Ass'n, 261 Md. 618, 277 A.2d 19 (1971); Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942), aff'd without opinion, 267 App. Div. 890, 47 N.Y.S.2d 589 (1944). See also Schwartz v. Romnes, 495 F.2d 844, 848 n.5 (1974). For the business judgment rule to apply, directors must act in good faith and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised their honest business judgment after due consideration of what they reasonably believed to be the relevant factors. See FLETCHER, supra note 16, §§ 1039-40. One commentator has noted that in a third party suit it is conceivable that a director can be in violation of a criminal statute in furtherance of corporate activity and yet still be fulfilling his obligations to the corporation in all good faith. See Note, Indemnification of the Corporate Official for Fines and Expenses Resulting from Criminal Antitrust Litigation, 50 GEO. L.J. 566, 570 (1962). It has also been recognized that a corporation may pay the fine imposed on a corporate officer or director who pleaded nolo contendere to settle a criminal antitrust suit, and such action will be sustained against attack in a shareholder's derivative action. See Koster v. Warren, 297 F.2d 418 (9th Cir. 1961). The court in the last case cited was careful to point out that it may well be that public policy would strike down any arrangement whereby a corporate officer could with immunity from personal liability involve his company in antitrust violations. However, such is not the case where there is at least a reasonable basis for concluding that a court could construe a complex statutory pattern to uphold a proposed transaction as lawful. On the other hand, where a violation of law is established, it has also been held that the business judgment rule will not insulate directors from liability, at least
corporation recovery against those responsible for authorizing the transaction will be denied, even where the business judgment rule may not be available as a defense. 87

Sections 5 and 35 of the Model Business Corporation Act, as amended in 1974, also afford guidance in considering the question of the director's liability for violation of law. Section 35 provides that

[a] director shall perform his duties as a director, including his duties as a member of a committee of the board on which he serves: (1) in good faith; (2) in a manner he reasonably believes to be in the best interests of the corporation; and (3) with the care that an ordinarily prudent person in a like position would use under similar circumstances.

The comment accompanying the amendment to Section 35 confirms that the standard set forth in the Section reflects the good faith concept embodied in the "business judgment rule." The comment notes:

By combining the requirement of good faith with the statement that a director must act 'with such care as an ordinarily prudent person in a like position would use under similar circumstances,' Section 35 incorporates the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business

where the violation in question involves an illegal payment or other action in violation of a strong and clear governmental policy. See Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974). See also Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947); Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909).

In Parish v. Maryland & Va. Milk Producers Ass'n, 250 Md. 24, 242 A.2d 512 (1968), on appeal after remand, 261 Md. 618, 277 A.2d 19 (1971), the Maryland Court of Appeals indicated that the ultimate determination that there has been a violation of law may not, per se, result in a finding of gross negligence or culpable mismanagement on the part of the directors. The court in its first opinion concluded that if the evidence established that the directors had deliberately purchased a business for a price far in excess of its actual value to eliminate competition and violate the antitrust laws, it prima facie an act of gross negligence and culpable mismanagement to proceed with the purchase, where on the basis of an existing judicial precedent it was apparent that a possible exception from the antitrust laws was so doubtful that the transaction should not have gone forward without prior Department of Justice clearance. However, in its subsequent opinion, the court of appeals sustained the conclusion of the trial court that the purchase in question did not constitute gross negligence or culpable mismanagement by the directors where they had good business reasons to acquire the business, had obtained appraisals and advice of counsel, and where the transaction had returned a profit and the business continued to be a substantial purchaser of the company's milk following court-ordered divestiture.

87. See Wilshire Oil Co. v. Riffe, 409 F.2d 1277 (10th Cir. 1969); Borden v. Cohen, 231 N.Y.S.2d 902 (Sup. Ct. 1962); Harris, Derivative Actions Based Upon Alleged Antitrust Violations, 37 Brooklyn L. Rev. 337 (1971). See also Bishop, Sitting Ducks and Decoy Ducks, 77 Yale L.J. 1078, 1101 & n.98 (1968); Forte, Liabilities of Corporate Officers for Violation of Fiduciary Duties Concerning Antitrust Laws, 40 Ind. L.J. 313 (1965); Note, Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions, 64 Colum. L. Rev. 174 (1964).
judgment. A director attempting to create profits for his corporation will frequently make decisions involving risk for the enterprise. No personal liability should be imposed upon him in the event his good faith decision, in the exercise of business judgment, later seems to have been erroneous.

This Section also provides that a director is entitled to rely on any information, opinion, report, or statement prepared by a lawyer as to a matter that the director believes to be within the lawyer's professional competence. This provision reflects the general principle that the standards of good faith and due care may be satisfied where the director selects counsel he believes to be competent, discloses to counsel all facts which he believes to be relevant, receives advice on matters of law when such advice is not so obviously erroneous as to make reliance on it unreasonable, and acts in accordance with such advice after it has been rendered.88

Section 5 of the Model Business Corporation Act permits indemnification of directors in proceedings brought by third parties, including payment of fines, if the director is determined to have acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation. This rule applies as well to any criminal proceeding, so long as the director had no reasonable cause to believe his or her conduct was unlawful. The termination of a proceeding by an adverse judgment, conviction, or plea of nolo contendere does not of itself create a presumption that the director's conduct does not meet the requisite standards for indemnification. In the case of derivative actions brought in the name of the corporation, indemnification is permitted as to expenses incurred, but not costs of settlement, if the director acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, but denies indemnification when a director is adjudged liable for negligence or misconduct in performing his or her duty to the corporation, unless a court specifically determines otherwise.

The comment to Section 35 of the Act, as amended, indicates that it was the intention of the draftsmen to parallel the business judgment standards applicable under Section 35 to the entitlement to indemnification under the provisions of the Model Act to the extent possible. A number of states have enacted provisions comparable to Sections 5 and 35 (as amended) of the Model Business Corporation Act, and it would

88. See generally Hawes & Sherrard, supra note 76. Section 35 does not indicate the type of opinion a director must receive in order to be entitled to rely. As noted above, the better view should permit reliance so long as counsel indicated that there is a reasonable basis for concluding the proposed course of action is lawful. See note 76 supra.
appear likely that these provisions will afford protection to directors who act reasonably in reliance upon advice of counsel when authorizing corporate action.\textsuperscript{89}

2. \textit{Limitations on a Director's Discretion in Responding to Evidence of Corporate Wrongdoing}

One of the most difficult tasks the directors must face is the development of an effective program for discovering corporate wrongdoing and preventing its reoccurrence. In carrying out this task the directors will be faced with problems similar to those faced by any law enforcement agency, including the difficulty of securing reliable evidence of wrongdoing, the need to protect the rights of potential accused, and the need to apply an appropriate but not overly harsh sanction to encourage disclosure while discouraging future misconduct. The directors will also carry certain additional burdens that a law enforcement agency need not carry. They must seek to encourage wrongdoers to step forward without the ability to afford effective immunity from potential criminal sanction and with the prospect that the information disclosed may under certain circumstances be required to be publicly reported. How should the directors proceed most effectively under these circumstances? There are no easy answers, but a few observations may be offered.

In sorting through the multitude of problems presented, the directors' obligation is to act in the long-term interests of the shareholders, and as neither protectors of corporate employees, nor as representatives of the public or of individuals who have been the immediate victims of employee wrongdoing. The long-term interests of the shareholders may under appropriate circumstances warrant offering some redress to victims of corporate wrongdoing in order to preserve the reputation of the corporation and mitigate possible governmental sanction. However, this does not mean that the role of directors should be muddied in this setting by imposing upon them obligations of public disclosure in-

\textsuperscript{89} An analysis of states which have enacted statutes similar to § 5 and the revised version of § 35 is contained in \textit{I \textsc{model business corporation act annotated} 87, 253} (Supp. 1977). Section 35 of the Model Business Corporation Act, as amended in 1974, states that a person who performs his duties as contemplated in that section "shall have no liability by reason of being or having been a director of the corporation." Neither § 35 nor the explanatory comment accompanying its amendment limits this language to liability to shareholders in derivative actions, and it is strongly arguable that reliance upon advice of counsel will also protect the director in suits brought by a governmental entity or other third party. However, it must be recognized that § 35 is not operative in case of suits based upon violations of federal law, and may not be conclusive protection even in states where it has been adopted if the violation of law complained of does not permit reliance upon advice of counsel as a defense.
consistent with their duties to the shareholders.90

The handling of information concerning corporate misconduct is a difficult task at best, since there will tend to be support, at least initially, for a manager who has performed well and in whom trust has been reposed by the institution. In addition, the accuracy and motives of the informant may be suspect for any number of reasons, including incomplete information, hearsay, reasonable disagreement over conclusions, concern over the informant’s own job performance, desire for advancement, or personal antagonism with fellow employees.

A further complication is that any potential informer may be reluctant to supply information even if his motives are pure. There may be feelings of loyalty to one’s superior and friends, or concern for individual or corporate retaliation.91 A person must have strong convictions to initiate the process of disclosure and, whether or not successful, thereby risk the loss of position and accumulated benefits.92 These problems are not peculiar to business corporations,93 and no institution

90. The knowledge that directors must, in every case, publicly disclose evidence of wrongdoing may serve effectively to discourage employees from stepping forward and disclosing their misconduct. Such an obligation placed on directors may also raise problems under insurance policies requiring the insured to cooperate with the insurer in conducting its defense. The government itself has recognized that with its limited resources more effective compliance with law may be obtained through encouragement of voluntary programs. See, for example, the SEC program on voluntary disclosure of sensitive payments described in the SEC QUESTIONABLE PAYMENTS REPORT, supra note 2, and the position taken by the Watergate special prosecutor in encouraging corporations to come forward and disclose illegal political contributions. Where those who are requested to cooperate and voluntarily come forward with disclosures face the prospect of certain public disclosure of their conduct and the possibility of adverse action by other agencies, there may well be less desire to make voluntary disclosures, thus perhaps frustrating any voluntary compliance program.

91. For a description of antagonisms that can develop within a business organization which preclude senior management from learning of problems on an operating level, see the examples cited in STONE, supra note 10, at 43-44. One unintended side effect of any requirement that a director act as a representative of the public may be to heighten this sort of attitude and frustrate compliance programs.

92. One unintended side benefit of the requirements for vesting of pension benefits imposed by ERISA may be to encourage employees to be more forthcoming in disclosing misconduct by their superiors in the organization. Some employees who have lost their positions as a result of disclosures have filed suit for damages against the corporation. See, e.g., N.Y. Times, Aug. 3, 1978, § D, at 1, col. 1. It is not yet clear whether evolving case law will grant protection to employees on some tort theory where they have no contractual right to continued employment upon which to rely. Compare McElroy v. Wilson, 143 Ga. App. 893, 240 S.E.2d 155 (1977) with Georgia Power Co. v. Busbin, 145 Ga. App. 438, 244 S.E.2d 26 (1978), rev’d, 250 S.E.2d. 442 (Ga. 1978).

93. A graphic illustration of the fact that governmental institutions are not immune from problems associated with employee “whistle-blowing” is the case of A. Ernest Fitzgerald and the actions taken against him by the Department of Defense as a result of his disclosures with respect to cost overruns on a government contract. See Hearings before the
handles them with ease. However, directors should consider establishing and publicizing institutionalized procedures through which employees with knowledge of wrongdoing may make such information known in a manner that will permit objective evaluation of the information. Care should be taken to avoid creating a totalitarian atmosphere by charging a separate group within the corporation with this responsibility. It would seem far preferable that some group that has other functions as well, such as the internal audit staff, be available to receive such information. Whoever receives the information should, of course, have a separate channel of communication to senior levels of the corporation. Procedures should be developed under which the internal audit staff does report to a senior officer with direct access to an audit committee of outside directors.94

Any compliance program must utilize professional legal services at some point to evaluate the legal consequences of information disclosed. In addition, attorneys should be involved from the outset in developing information through interviews of witnesses and review of documents since their training in cross-examination and evaluation of information will be essential to any thorough investigation. There will be the inevitable risk of confusion as to whom the attorney is representing while interrogating employees, particularly if the attorney is one with whom the employee in question has regularly worked in the past (and perhaps advised on some personal matters). There may be a need to warn an employee of his rights and the consequences flowing from disclosure, with the resultant risk of discouraging disclosure because even when the corporation may not intend to discipline employees, law enforce-

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The problems become particularly acute when the party in question is a member of senior management and the board of directors. The directors should seek to establish as part of any compliance program a committee of nonmanagement directors to handle such situations when and if they arise. As a preliminary, careful consideration should be given as to who will conduct the investigation, and whether the individuals concerned should have separate counsel.

In any event, it must be settled from the beginning that the attorney who is conducting the investigation is acting on behalf of the corporation, and that any report furnished to the supervising board committee to assist in determining how the corporation can best effectuate compliance with the law is intended to be a privileged attorney-client communication. While any facts developed by the attorney will of course be subject to discovery as not falling within the scope of the privilege, the better view is, as illustrated by the reasoning employed by the Court of Appeals for the Eighth Circuit in *Diversified Industries*,

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95. See, in this connection, United States v. Handler, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,519 (C.D. Cal. 1978), where the report of Special Counsel appointed by a corporation pursuant to an SEC consent decree ultimately led to criminal prosecutions. Under some decisions, the corporation may be held criminally responsible for acts of its employees even in violation of corporate policy, and therefore have a common objective with the employee in avoiding prosecution. See United States v. Hilton Hotel Corp., 417 F.2d 1000 (9th Cir. 1972), cert. denied, 409 U.S. 1125 (1973); United States v. American Radiator and Standard Sanitary Corp., 433 F.2d 174 (3d Cir. 1970), cert. denied, 401 U.S. 948 (1971); U.S. v. Armour & Co., 168 F.2d 342 (3d Cir. 1948). Where an investigation is not conducted under the requirements of a consent decree providing for public filing of a report, there may be a basis for disclosures to an attorney to be protected under a theory of "joint defense." See Hunydee v. United States, 355 F.2d 183 (9th Cir. 1965); Continental Oil Co. v. United States, 330 F.2d 347 (9th Cir. 1964); *In re Grand Jury Subpoena*, 406 F. Supp. 381 (S.D.N.Y. 1975); Note, *The Attorney-Client Privilege in Multiple Party Situations*, 8 COLUM. J.L. & SOC. PROB. 179 (1972); Note, *Waiver of Attorney-Client Privilege on Inter-Attorney Exchange of Information*, 63 YALE L.J. 1029 (1954); C. Mccormick, Evidence § 91, at 189 (2d ed. 1972); 8 J. Wigmore, Evidence § 2312, at 603 (McNaughton rev. 1961). However, it must be clear that the attorney is in fact acting as counsel for the employee being interrogated and not simply as counsel for the corporation. *See In re Grand Jury Proceedings*, 434 F. Supp. 648 (E.D. Mich. 1977); State of Illinois v. Harper & Row Publishers, Inc., 30 F.R.D. 37 (N.D. Ill. 1969), rev'd in part sub nom. Harper & Row Publishers, Inc. v. Decker, 423 F.2d 487 (7th Cir. 1970), aff'd by equally divided court, 400 U.S. 348 (1971). Those conducting the investigation will wish to consider carefully the necessity of warning a potential object of the investigation of possible criminal prosecution should the information disclosed by the investigation ultimately be made public. On the other hand, such warnings may serve to chill the willingness of employees to cooperate and frustrate the purpose of the investigation in circumstances where the corporation has no power to grant immunity and no intention of proceeding in a punitive fashion against the employees in question.
Inc. v. Meredith, 96 that the report itself is a privileged communication. This view will better serve the public by making board committees free to undertake vigorous compliance programs and receive reports from counsel on their effectiveness, without fear of generating reports subject to discovery in adversary proceedings.

One final development should be noted. There has been an increasing tendency of late for the Enforcement Division of the SEC to require the appointment of special counsel to conduct or review investigations carried out by board committees in settlement of enforcement procedures. At least two potential problems emerge from this procedure. First, confusion may develop as to whether the counsel is to be viewed as acting for the committee and subject to the attorney-client privilege. 97 Second, a report will normally be required to be publicly filed, which may result in a waiver of the attorney-client privilege. There are no clear or easy answers to these problems, and the most that can be said is that any such settlement should carefully define the special counsel’s role as counsel to the board committee, seek to preserve the attorney-client privilege to the extent possible, and limit any obligation to file a public report to one containing only material information necessary for the protection of investors.

Once an investigation has been completed, the directors, acting as a board or through a board committee, must consider the question of discipline of those involved in any misconduct. As with any court, the board or committee must weigh many factors, including any personal benefit derived by the employee from his actions, the gravity of the offense, the harm suffered by the corporation, the value of the employee to the corporation, the ability of the individual to make restitution, and the necessity of imposing discipline to deter future misconduct. The board or committee should have broad discretion, in the exercise of sound business judgment, to determine whether to censure, demote or terminate the employee, or demand restitution. So long as there is a reasonable basis for this decision and it is not the result of personal interest, courts should refrain from second-guessing. 98 Institutionalized objectivity in corporate decision-making will

98. A number of decisions reflect the inclination of courts to accord such deference to the business judgment of disinterested directors. See United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Hawes v. Oakland, 104 U.S. 430 (1881); Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Stadin v. Union Elec. Co., 309 F.2d 912 (8th Cir. 1962), cert. denied, 373 U.S. 915 (1963); Swanson v. Traer, 249
encourage courts to refrain from such second-guessing.99

Finally, the directors must determine whether the results of their investigation are to be publicized. The inquiry may reveal the existence of potential contingent liabilities which, if publicly disclosed, might well stimulate litigation against the corporation to the detriment of its existing shareholders. Although this subject has been a source of vigorous debate,100 it would appear that the directors should normally be guided by the practical guidelines set forth in FASB No. 5, which authorizes specific disclosure of only those uninsured, unasserted contingencies as to which there is already a probability of assertion against the corporation and a reasonable possibility of successful recovery in a material amount.101 The directors will want to receive assurance that the corporation has made adequate provision in its reserves for any losses it might suffer. In any event, should the investigation disclose a practice, the cessation of which may have a material adverse impact on


99. Query whether as a result of the decision in Lasker v. Burks, 567 F.2d 1208 (2d Cir.), cert. granted, 47 U.S.L.W. 3221 (1978) (No. 77-1724), courts in the future will also look to the process by which directors are elected as a factor in determining their objectivity. If such should come to be the case, this should be a substantial factor in encouraging the use of effective nominating committees to select directors for boards of directors of public corporations.

100. See, for example, the proposal submitted by a public interest group that would have the SEC adopt a rule requiring an attorney to disclose the fraud of his client. [1978] Sec. Reg. & L. Rep. (BNA), No. 456, at A-11.

the corporation’s present or future business, or indicates that a senior manager or director was involved in personal wrongdoing, appropriate public disclosure should be made.

D. Provision for long-range planning

Although the proper role of directors does not include involvement in the daily operation of the enterprise, the board should ensure that management has adequately planned for the future of the enterprise. Relevant areas include changing demands for and profitability of the corporation’s products or services and requirements for physical facilities, staffing, and resource availability. The principal tools of the board in fulfilling this role are forecasts prepared by management for planning purposes.\(^{102}\)

Having reviewed those broad areas in which directors can reasonably be expected to take some initiative, it is now appropriate to consider the extent to which there should be differentiation among directors as to the tasks they are called upon to perform, a question briefly touched upon above.\(^{103}\)

**Why Differentiate Among Directors?**

One of the sharpest items of dispute in the current debate over corporate governance concerns eligibility requirements for directors. The classification utilized in the Corporate Director’s Guidebook (prepared by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association) distinguishes between “management,” “affiliated non-management,” and “unaffiliated non-management,” but leaves it to the board of each

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102. It has been suggested that disclosure be required of the board’s criteria for evaluating management’s performance. See Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 LAW & CONTEMP. PROB. 63, 105-07 (1977). As a practical matter, the board normally monitors management’s criteria for acceptable profitability of products, services or business segments. The important issue is whether such criteria have been formulated and are being applied in formulating the corporate budget and long-term forecast. Problems of maintaining confidentiality of business plans with respect to many factors considered in the budget, including new product planning and pricing strategies, would appear to make it questionable whether public discharge of such criteria could be made in useful form. There is a hazard in setting up a committee on long-range planning and then having the committee take no action. See, in this connection, a recent law suit filed against the directors of W.T. Grant & Co. alleging, *inter alia*, that the long-range planning committee never met “due to the emergency nature of Grant’s then-existing short term problem.” Wall St. J., April 12, 1978, at 10, col. 2.

103. See notes 54-64 & accompanying text supra.
corporation to make the appropriate determination. The Chairman of the SEC has indicated that he believes all directors, save the chief executive officer, should be nonmanagement directors.

This process of differentiation among directors produces at least two troublesome phenomena. First, it necessitates drawing sharp lines between types of directors in order to be able to fit all directors into the classifications created. Second, it creates a tendency to conclude that certain directors are, by virtue of their classification, somehow endowed with characteristics particularly desirable for the purposes of corporate governance. However, neither the infinitely varied types of individuals who people the boards of our public corporations nor the dynamics of board conduct give much assurance that such classifications can have more than limited utility at best, since the best guarantee of good performance in the last analysis must rest with the individual character traits of each director.

Differentiation among directors, however, does serve to clarify the responsibilities directors may fairly be called upon to assume, and it

104. See Corporate Director's Guidebook, supra note 4. The Corporate Director's Guidebook classifies non-management directors as "affiliated" and "unaffiliated." The SEC Proposed Governance Rules would have required identification of directors as "management," "affiliated non-management" or "independent," and set forth detailed rules for classifying directors. See Proposed Governance Rules, supra note 2, Schedule 14A, Item 6. Following substantial critical comment on the proposal, the SEC chose not to require such identification in the final SEC Corporate Governance Rules, and required only disclosure of specified relationships. See Corporate Governance Rules, supra note 2, amending 2 Fed. Sec. L. Rep. (CCH) ¶ 24,037, Schedule 14A, Item 6(b).


106. Specific note might be made in this connection of the problem of classifying retired management directors. A retired management director who has vested retirement benefits may, for many purposes, be more "independent" and objective as to matters not involving actions or policies for which he was responsible while active in the company than a non-management director who is a supplier of goods or services to the corporation and who may be dependent upon future good will of present management in some material way for continuation of his business relationship. However, in the usual case it would seem to be better practice not to count either director as "unaffiliated non-management" in determining the appropriate composition of an audit, compensation, or nominating committee. The SEC in its Corporate Governance Rules requires disclosure of the fact that a director has in the last five years been an officer or employee of the issuer or any of its parents, subsidiaries or other affiliates. See Corporate Governance Rules, supra note 2, amending 2 Fed. Sec. L. Rep. (CCH) ¶ 24,037, by adding Item 6(b)(1) of Schedule 14A.

107. For example, is an "independent" director any more sensitive to broad public policy issues affecting the corporation than a "management" director?

108. It was for this reason that the Corporate Director's Guidebook, supra note 2, left it to the sound discretion of each board of directors as to how to classify individual directors and as to how each board should ultimately be composed.
gives some minimum guarantee of objectivity in discrete decision-making situations. A necessary corollary to this latter purpose is that there be an overall board environment conducive to the exercise of such objectivity. Each of these purposes will be examined in turn.

Defining Director Responsibility

Defining the responsibilities directors can be fairly called upon to assume requires, at the outset, an inquiry into whether any distinction should be drawn between those directors who are involved in the actual management of the enterprise and those who are not.

The tendency has been to separate for purposes of analysis the management role and the oversight role assigned to directors, particularly the so-called "outside" or nonmanagement directors. The 1974 amendment to Section 35 of the Model Business Corporation Act sought to draw this distinction by stating that "the business and affairs of a corporation shall be managed under the direction of" a board of directors, rather than "by" a board of directors. This amendment emphasizes the limited role that directors qua directors should play in the actual operation of a large business enterprise.

However, it must be recognized that stating the dichotomy between management and oversight so simply inevitably blurs what is in fact a much more complex governance process. Effective management itself involves the ability to obtain the data necessary for informed decision-making, the ability to act objectively in evaluating the data obtained, and the ability to make and effectively implement decisions based on the data. The larger the business enterprise, the more this management process devolves upon the skills of submanagers to whom responsibility has been delegated. For example, the chief executive officer of a large enterprise should not be concerned with the selection, compensation, promotion, and separation of each person who occupies a supervisory role in the enterprise, or of each supplier with whom the enterprise transacts business; but he or she can be expected to establish criteria that will guide such decisionmaking by responsible subordinates.109

109. For example, he will be expected to adopt policies which make clear that hiring, compensation, promotion and separation of subordinates is to be accomplished in a manner which does not discriminate as to sex, age, race, religion or natural origin. Similarly, he will be expected to adopt policies which insure that goods and services are procured insofar as possible from more than one source to enhance competition from suppliers both as to price and service, and to minimize the risk of "favoring" one supplier due to covert relationships between the supplier and the enterprises' purchasing agents. Where there is such a relation-
As the importance of the particular decision to the enterprise increases, analysis, evaluation and approval will occur at a higher level on the management ladder. Executives occupying higher levels of responsibility will be selected and compensated in turn by increasingly higher levels of management. At some point, employment and compensation of managers at a high enough level may be subject to review by a committee of the board of directors, such as a wage and compensation committee. However, even that committee will not normally perform the "management" task of evaluating the performance of any but the most senior executives of the enterprise. Similarly, decisions relating to the acquisition of property, and development and distribution of new products and services, will normally be made in the context of development and implementation of capital budgets, prepared with input from operating divisions, and ultimately executed by those divisions. Overall capital budgets may often be presented to the board of directors or a finance committee of the board for review, but unless the budget is of a size to require the raising of additional capital or the borrowing of additional funds, the board may not be asked to take specific action thereon.

The foregoing analysis is intended to emphasize that even the process of "management" does not produce a clear division between the "managers" and the "managed," since in the very process of decision-making senior managers must rely on their subordinates. In fixing responsibility for corporate behavior, such reliance should be permitted within reasonable limits, so long as senior management has developed basic criteria to guide decisionmaking at lower levels, and sufficiently supervise decisionmaking to insure objectivity and compliance with the law. Nonetheless, even if senior managers can demonstrate this quantum of care, courts are likely to hold them to a higher duty of inquiry and knowledge of corporate conduct than will be required of non-management directors because of the responsibility for the day-to-day operations of the enterprise. Although this appraisal may be accurate,

ship, its existence should be disclosed through periodic submission of conflict of interest statements required of all employees in a position to make decisions for the enterprise.

110. The developing case law seems to support this view. See cases cited note 58 supra. See also ALI FED. SEC. CODE § 1704(g) (Proposed Official Draft, 1978). Section 35 of the Model Business Corporation Act did not address the right of an officer to rely on reports of subordinates but concluded that it was not appropriate in connection with the provisions of § 35 to deal with officers who were not also directors of the corporation, noting that although a non-director officer may have a duty of care similar to that of a director as set forth in § 35, his ability to rely on information, reports or statements, may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation. See Com-
it would be well to recognize that, in reality, it may be as unfair to impute knowledge of particular corporate behavior to any given management director as it would be to impute such knowledge to the non-management directors, especially considering the often extensive scope of operations of the enterprise involved. It may well be that as directors' responsibilities come to be defined more in terms of ensuring that appropriate programs have been instituted to deal with the greater number of problems brought to the attention of the board, the distinction between management and non-management directors will tend to blur, and the focus will shift to what is fair to impute to the individual director, given his particular responsibilities in and knowledge of the enterprise.\textsuperscript{111}

In assessing responsibilities of directors, some differentiation may also be made between directors who serve on particular committees and those who do not serve. Sections 35 and 42 of the Model Business Corporation Act, as amended in 1974, seek to draw such a distinction by permitting noncommittee directors to rely on committee reports so long as they have exercised reasonable care in delegating responsibility, and have otherwise complied with the standard of care provided in Section 35.\textsuperscript{112}

\textsuperscript{111} ALI FED. SEC. CODE § 1704(g) (Proposed Official Draft, 1978) may implicitly recognize this fact by not drawing any clear distinction between management and non-management directors but simply stating generally that relevant circumstances in determining what constitutes reasonable investigation or care and reasonable ground for belief include not only the office held when the defendant is an officer and the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, but also the type of the registrant, the type of defendant, and reasonable reliance on officers and employees and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular defendant with respect to the registrant and filing), and whether with respect to a fact or document incorporated by reference, the particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated. The SEC recently had occasion to consider the question of responsibility for documents incorporated by reference in connection with the liability of underwriters with respect to short-form registration statements on Form S-16. See SEC Securities Exchange Act Release No. 5998,\textsuperscript{1978 Transfer Binder} FED. SEC. L. REP. (CCH) ¶ 81,761.

\textsuperscript{112} The comment to the amendment to § 42 of the Model Business Corporation Act, reprinted in Corporate Director's Guidebook, supra note 4, Appendix B, indicates that a noncommittee member's liability would depend upon whether he failed to comply with § 35 and that "[f]actors to be considered in determining whether or not the requirements of Section 35 had been met would include the care used in the delegation to and surveillance over the committee, and the amount of knowledge regarding the particular matter which the noncommittee director has available to him. Care in delegation and surveillance would include appraisal of the capabilities and diligence of the committee directors in light of the subject
Although such a right of reliance may well mean that those directors who are members of committees may assume a greater burden in particular instances, this does not mean that noncommittee directors can abdicate responsibility for committee actions. Noncommittee members are obligated to at least procure and read committee minutes with a view toward confirming that the committees are carrying out their prescribed responsibilities.

**Assuring Objective Decision-making**

The board of directors upon occasion may be called upon to review and make decisions on matters in which one or more directors will have a personal interest. Some of these situations will recur in the normal course of business, such as the ongoing process of evaluation and compensation of senior management; other situations, such as allegations of questionable practices, usually will arise only infrequently and can be dealt with on an *ad hoc* basis. Whenever such situations are presented, it is important to both the corporation and the individual concerned that the decisionmaking process be as objective as possible. Action taken by directors not interested in the subject under discussion not only lends credibility to the concept of accountability to the shareholders, but also gives protection to the individuals involved against shareholders seeking to question the directors' actions.\(^\text{113}\)

It would, of course, be possible to approach each case of self-interest on an *ad hoc* basis and attempt to select disinterested directors to review the case at that time. However, there are sound reasons for identifying in advance those directors who will participate in the review process.

First, those recurring situations most appropriately handled by working committees of the board of directors, such as the compensation and audit committees, require advance appointment of a signific...
cant number of directors to staff committees if they are to function effectively. Second, some orderly procedure should be arranged for committee assignments, rotation on committees, selection of new directors, and retirement of directors. In order to enhance the credibility of this procedure, it should be carried out by a disinterested nominating committee of directors.\footnote{114} What, in effect, is required is a procedure for institutionalized objectivity. As increased attention is focused on the manner in which corporate boards operate, such institutionalized procedures may soon be viewed as important criteria in determining whether actions taken by a board merit the deference to be accorded to objective decisionmaking.\footnote{115}

If such institutionalized objectivity is to be accomplished, some differentiation among directors is required, and the differentiation is most appropriately made between those directors who are most likely to be involved in activities requiring disinterested review and those directors who are not. Evaluation and compensation of senior managers and review of the enterprise's financial performance are to be expected on an on-going basis, and, therefore, the differentiation is normally to be made between so-called management and nonmanagement directors. However, in making this differentiation, it is important not to lose sight of the fact that such differentiation is being undertaken solely for the purpose of institutionalizing objective decisionmaking in situations where self-interested transactions are expected to recur. Such differentiation carries with it no valid judgment that nonmanagement directors have any innate traits of character or other qualities that make them better able than "management" directors to monitor the operation of the business enterprise or more responsive to the shareholders or any other constituency served by the corporation. Similarly, differentiation between "affiliated" and "unaffiliated" or "independent" directors should be drawn only to enhance the credibility of the decision-making process in self-interested transactions, by eliminating the danger of "back-scratching", and not for the purpose of encouraging the drawing of any other inferences.\footnote{116}

\footnote{114} This is the recommendation of both the Corporate Director's Guidebook, supra note 4, and the Business Roundtable Statement, supra note 6. This approach is not a wholly novel one. See M. Eisenberg, The Structure of the Corporation 176-77 (1976).

\footnote{115} As noted above, action by disinterested directors may shift the burden of proving unfairness or foreclose the initiation of a derivative shareholder action. See cases cited notes 19, 98 supra; Lasker v. Burks, 567 F.2d 1208 (2d Cir.), cert. granted, 47 U.S.L.W. 3221 (1978) (No. 77-1724).

\footnote{116} The danger of injecting such judgments into definitions of "independence" is highlighted by the SEC's Proposed Corporate Governance Rules in which a "control person" of
It is important that decisions affecting the corporation be made as objectively as possible, while maintaining the traits of judgment, character, and experience necessary to conduct the affairs of the enterprise. It is perhaps inevitable that any undertaking to define what makes a director "unaffiliated" will be negative, in that it will essentially call for demonstrating the absence of relationships likely to affect the director's objectivity. However, defining "unaffiliated" in this manner carries with it certain risks.

First, such a definition may obscure the reason for identifying the "unaffiliated" director (to enhance objectivity in self-interested transactions) and lead to unwarranted expectations as to the performance to be expected of those who fulfill that role on the board. Second, it will inevitably produce disputes as to which relationships constitute "affiliations" that disqualify an individual from being characterized as an independent director. Third, to the extent that the Government seeks to involve itself in the resolution of these disputes, even indirectly by the issuer was automatically deemed to be an "affiliated non-management director." See Proposed Governance Rules, supra note 2, ¶ 81,645, at 80,578, Instruction (8). By what process of alchemy is a substantial shareholder who has no other relationship with the corporation in a management capacity transmuted into an affiliated director? Presumably, such a shareholder would have the greatest stake in the proper governance of the corporation and should be fully qualified to sit on committees of non-management directors such as the compensation, audit or nominating committees. Only in the case of participation in a discrete transaction with the corporation involving such an individual's self-interest should the transaction be reviewed by other directors not interested in the transaction. Cf. Puma v. Marriott Corp., 283 A.2d 693 (Del. Ch. 1971). As finally adopted, the SEC Corporate Governance Rules continue to require disclosure of the fact that a director is a control person of the issuer (other than solely as a director of the issuer). See note 37 supra.

117. For a description of the qualities of character believed important in the individual director, see Corporate Director's Guidebook, supra note 4.

118. The question as to whether a control person who is not involved in management of the enterprise should be deemed "affiliated" is an apt example. See note 116 supra. Particular industries may also require practical judgments in applying tests of affiliation. For example, in the banking industry traditionally banks have sought to place on their boards as directors substantial businessmen in the community who would place in the bank the deposits of their businesses for the bank's benefit. So long as such a director's transactions with the bank are subject to careful scrutiny by bank examiners and so long as such lending transactions are carried out at a prime rate fixed by competition in the marketplace and justified because of the size of the particular entity and reviewed by other directors, there does not seem to be much risk involved in permitting such directors to continue to serve on bank boards. Indeed, such directors, because of the deposits which their companies maintain with the bank, have a particular interest in seeing that the bank is safely and prudently managed. Those hard cases, where banks made loans in excess of legal limits to insiders, should not require a change in the entire corporate governance structure, and recent extensive legislative changes dealing with supervisory authority over financial institutions do not attempt to make such changes. See, Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, §§ 101-113, 201-209, 92 Stat. 3641.
disclosure requirements, it may burden the task of director selection with bureaucratic procedures that place undue emphasis on the absence of affiliation and make the process of recruiting directors more cumbersome.\textsuperscript{119}

The foregoing risks are not intended to suggest that disclosure of director affiliations would be inappropriate, but rather to emphasize that care must be taken in the manner in which disclosure is made. It should be sufficient to require a corporation to disclose in its proxy material the relationships that each director has that might affect his or her objectivity, and in general to eschew the process of attempting to pigeon-hole directors by applying labels of management, nonmanagement, affiliated, and independent to each director.\textsuperscript{120} In the final analysis, the board of each corporation must recommend to its shareholders the proper mix of individuals on its board. If the board’s selections and committee structure fail to create an environment conducive to objective decisionmaking, the board will inevitably be penalized when particular transactions are tested in the courts, as judges can be expected to scrutinize with increasing frequency the realities of board environment when dealing with interested transactions.\textsuperscript{121}

\textsuperscript{119} The experience with administration of the Investment Company Act of 1940 is instructive in this connection. As to whether an individual proposed as a director of a registered investment company constitutes “an interested person” under § 2(a)(19) of that Act, see [1978] SEC. REG. L. REP. (BNA), No. 460, at C-2. The SEC Proposed Corporate Governance Rules stated broadly that notwithstanding the definition of “independent director,” if the issuer were aware of other relationships between a nominee or the issuer or its affiliates which, under the circumstances, could reasonably be viewed as interfering with such nominee’s exercise of independent judgment, reference to such nominee as a “independent director” would be inappropriate. \textit{See Proposed Governance Rules, supra} note 2, ¶ 81,645, at 80,578-79. If the proposed regulations had been adopted, corporations might have felt obliged in case of doubt to seek rulings from the SEC staff on the accuracy of their disclosures as to whether directors were “independent” or “affiliated” or run the risk of Enforcement Division proceedings. Since the SEC Corporate Governance Rules as finally adopted avoid any requirement that directors be specifically identified as “management,” “affiliated non-management” or “independent,” there should be less pressure on reporting companies to fit all directors in one of three categories. However, disclosure is still required of all relationships between the director and the issuer or its management substantially similar in nature and scope to those specifically required to be disclosed. \textit{See Corporate Governance Rules, supra} note 2, amending 2 FED. SEC. L. REP. (CCH) ¶ 24,037, by adding Item 6(b)(7) of Schedule 14A.

\textsuperscript{120} The SEC Corporate Governance Rules make clear that labels may only be utilized to connote a lack of relationship to the issuer and its management where there is an absence of significant business or personal relationships between the director and the issuer or its management. \textit{See Corporate Governance Rules, supra} note 2, amending 2 FED. SEC. L. REP. (CCH) ¶ 24,037, by adding Item 6(b)(7) of Schedule 14A.

\textsuperscript{121} \textit{See Berkman v. Rust Craft Greeting Cards, Inc.,} [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,515 (S.D.N.Y. 1978), where the court emphasized the materiality to
To What Extent Should Directors Be Made Subject To Shareholder Direction In Carrying Out Their Responsibilities?

The legal theories through which the governance mechanism of the modern American business corporation has evolved reflect a curious paradox. Although some courts have suggested that shareholders do have the right to assert themselves in connection with how their corporations are governed, modern corporation statutes, with limited exceptions, do not vest in shareholders the power to initiate or direct corporate action. The board of directors generally has been vested with the responsibility for managing, or more recently, overseeing the management of the corporation as fiduciaries for the shareholders. While the directors share this power to some extent with their shareholder “beneficiaries” through the joint exercise of certain fundamental powers, such as the amendment of the charter and the approval of certain types of corporate combinations, the shareholders’ prime statu-

shareholders of a director’s “track” record, in concluding that a third-party adverse conflict of interest known to directors should have been disclosed to shareholders as reflecting on the director’s integrity and fitness. See also Lasker v. Burks, 567 F.2d 1208 (2d Cir. 1978), cert. granted, 47 U.S.L.W. 3221 (1978) (No. 77-1724); Cramer v. General Tel. & Electronics Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,510 (3d Cir. 1978); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). The reliance by directors on the advice of counsel may also increasingly be emphasized by the courts in examining the objectivity of the board’s decisionmaking process. See Wright v. Heiser, 560 F.2d 236, 248, 252 (7th Cir. 1977); Hawes & Sherrard, supra note 77, at 24-25. It may therefore become important for corporations to follow the example of General Motors and provide that the power of appointment (and removal) of the General Counsel rests with the Board of Directors. See General Motors Corporation By-Laws, Art. 59.


124. See ALI-ABA MODEL BUS. CORP. ACT § 35 (1974); FLETCHER, supra note 16, § 838.

125. Even these provisions for sharing of power may be diluted by grants of authority to directors who determine the rights, preferences, privileges and limitations applicable to preferred stock through certificates of determination of preferences and may in the case of corporate business combinations be avoided entirely by the manner in which the transaction is structured. Some limitations on this avoidance may be imposed by stock exchange require-
tory remedy for expressing dissatisfaction with director action is the theoretical power of removal. In the case of the large, publicly held corporation this power is capable of use only by someone with the financial resources to mount a proxy fight or tender offer. Accordingly, the question must be asked whether this statutory framework should be modified in some fashion so as to provide shareholders with a more effective means of lending guidance to the board of directors.

It is not surprising that there would be some sympathy for the concept of "shareholder democracy" in a country such as ours where governmental institutions are made subject to such direction through the process of the initiative. The recent phenomenon of tax legislation through the initiative process in California might be thought to encourage such sentiments with respect to other large institutions, governmental or private, which have a substantial impact on our citizenry.

There are, however, differences between the phenomenon of direct citizen action through the initiative process and the prospect of direct shareholder action to control corporate decisionmaking that mandate caution before carrying the analogy too far.

First, it is not clear that the shareholders of American business corporations share the same enthusiasm for the initiative process as the citizenry at-large as applied to the corporate sector. A substantial portion of the voting shares of publicly held corporations are held by institutions acting for the benefit of others, often in a fiduciary capacity. Such institutions typically have not sought in the past to take an active role in supervising management. Unless and until there is a clear manifestation that a substantial portion of the shareholding public believes

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126. The various state statutes authorizing removal of directors are analyzed in 1 Model Business Corporation Act Annotated 812 (2d ed. 1971).
127. A Library of Congress survey indicates that 23 states presently have initiative procedures and that during the past 80 years a total of 1200 proposals have been submitted through this process. See San Francisco Chronicle, May 15, 1978, at 10, col. 1.
128. However, it is significant that none of the suggestions for governance submitted in the recent SEC hearings apparently contemplated any such direct stockholder action. See SEC Staff Summary, supra note 2.
129. Eleven major groupings of institutional investors combined held $341.5 billion or 34.3% of total stock outstanding in the United States at the end of 1977, according to preliminary estimates released by the SEC. See SEC News Digest No. 78-118, June 19, 1978. Such institutions would include shares held by pension funds, mutual funds, and bank trust departments.
such right of access is worth the cost, it would seem a dubious policy to commit any substantial portion of the efforts of regulatory agencies to achieving such a result.\footnote{130} Second, many of the contemporary concerns with corporate conduct that might render direct access to corporate government superficially appealing relate to issues ill suited for resolution through that process,\footnote{131} either because they involve public policy

\footnote{130} Some suggestions were made in the recent SEC corporate governance hearings that at least some changes in corporate oversight procedures be instituted only with the approval of the shareholders of each corporation involved and not by rules of universal application. See SEC Staff Summary, supra note 2, ¶ 81,653, at 80,660. It might be argued that if beneficial holders of shares held by institutions were given pass-through voting rights, a more direct access by the public could result. Even without considering the practical problems caused by any such generally attempted pass-through, the SEC's own past experience has been that the public at large is not all that interested in particular public interest issues. See SEC Securities Exchange Act Release No. 5627 (1975), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,719-21 (Proposed Environmental Disclosures), where the commission stated: "The Commission's experience over the years in proposing and framing disclosure requirements has not led it to question the basic decision of the Congress that, insofar as investing is concerned, the primary interest of investors is economic. After all, the principal, if not the only reason why people invest their money in securities is to obtain a return. A variety of other motives are probably present in the investment decisions of numerous investors but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed." See also SEC Securities Exchange Act Release No. 5704 (1976), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,495 (Rulemaking on Environmental Disclosure), describing the proceedings engendered by litigation instituted by the National Resources Defense Council, as a result of which the Commission compiled an estimated 15,000 pages of comments, testimony, memoranda, and data over a five-year period. The Commission noted that the approximately 100 participants in the proceedings who identified themselves as investors who consider such information important constituted an insignificant percentage of the estimated 30,000,000 United States shareholders and those who identified their interest holdings constituted approximately two-thirds of one percent of the estimated aggregate value of the common and preferred stock and corporate bonds held in the United States at the end of 1974. The Commission also noted that while the proceedings were given considerable publicity, no one was required to respond and the number who did so was relatively small, considering the fact that investors number in the millions. See Securities Exchange Act Release No. 5627, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,719-20. This same result has apparently been experienced by the private sector. American Telephone & Telegraph Co. has indicated that of the 465,000 communications from shareholders which it received in 1977, only one-fifth of one percent related to corporate governance, and the vast majority dealt with matters of economic interest. Others have indicated a similar lack of interest by shareholders in socially significant information. See SEC Staff Summary, supra note 2, ¶ 81,653, at 80,637-38, 80,640, 80,648. Furthermore, extensive changes in shareholder voting procedures may not be necessary in any event to permit a determined group of shareholders to make their point, so long as the SEC staff is flexible in permitting shareholder resolutions to be placed in proxy statements. See N.Y. Times, April 9, 1978, § 3, at 1, col. 3; N.Y. Times, April 9, 1978, § 3, at 8, col. 4.

\footnote{131} The courts have attempted to distinguish between suits by stockholders seeking to vindicate public interest issues from suits by stockholders who were concerned for the welfare of their corporation. See, e.g., Pillsbury v. Honeywell, Inc., 291 Minn. 322, 191 N.W.2d
issues more appropriately resolved through governmental institutions\textsuperscript{132} or because they involve individual instances of misconduct that must in any event be handled on a case-by-case basis.\textsuperscript{133}

The conclusion that there are practical limitations on increased shareholder participation in the corporate governance process does not, of course, mean that directors are entitled to ignore the views of their shareholders. Indeed, it is important that directors not allow their own individual predilections to obscure the broader objectives of the corporation.\textsuperscript{134} This perspective will become particularly important as the extent to which corporations should participate in the political process in light of the recent \textit{Bellotti} decision is considered.\textsuperscript{135} It would be unfortunate to see corporate boards unduly hamstrung in commenting on issues of public importance that are relevant to the corporation's business operations. However, it would be equally unfortunate if the business community were to accept the \textit{Bellotti} decision as a broad mandate to take stands on all public issues, whether or not relevant to the success of the particular business enterprise. To do so might lend credence to the contention that, at least in the area of public comment, the voice of the shareholders should be heard before the corporation itself speaks.\textsuperscript{136}

\textsuperscript{132} Consider, for example, the problems, including foreign relations problems, relating to investment in South Africa.

\textsuperscript{133} See notes 69-101 & accompanying text \textit{supra}. In addition to the problems noted in the text, any initiative process has the additional problem of effectiveness in dealing with complex issues on which the shareholder has limited information and as to which the corporation may be under some constraints as to public disclosure.


\textsuperscript{136} Consideration might be given to having a board committee—such as a social or public responsibility committee—review corporate advertising and contributions involving matters of general public interest before action is taken by the corporation on such matters. See, on a related subject, the recommendation of the \textit{FIFTY-FOURTH AMERICAN ASSEMBLY ON CORPORATE GOVERNANCE IN AMERICA} 8 (1978) that procedures be established by corporations for hearing the concerns of groups affected by corporate actions, and that a public issues committee of the board should assure that these procedures are utilized by management to weigh the consequences of corporate action.

There are steps that a board may take to be responsive to its shareholders in the area of corporate governance. It can, through the board’s nominating committee, receive shareholder suggestions regarding potential nominees for the board of directors. It can also take the initiative in responding to shareholder concerns about particular corporate actions by seeking to explain to the shareholders its position on controversial issues, rather than avoiding discussion of these issues by opposing inclusion of shareholder proposals in proxy statements as not relevant to the corporation’s business. Acknowledging the expense of such a policy, there is, nonetheless, a certain therapeutic process involved in requiring the senior management and board to articulate clearly the reasons for their corporation’s position on issues of public concern. Furthermore, management may find it more productive in the long-run to concentrate on responding at shareholders’ meetings to certain issues known to be of interest to shareholders, rather than attempting to divine in advance what questions will be asked.

Conclusion

As the current interest in corporate governance continues to spark debate, this article has attempted to present a useful frame of reference for considering issues related to the structure, composition, and responsibilities of boards of directors. What is now required is an effort to broaden the base of corporate boards by identifying individuals with the experience, temperament, and commitment necessary to make them effective contributors to the process of corporate governance as non-

137. Consideration must, of course, be given to whether the particular question represents simply an isolated attempt by one shareholder or a limited number of shareholders to gain attention or represents a fairly pervasive concern of a number of shareholders.

138. The Prime Minister’s Question Hour in the English House of Commons offers a useful analogy. However, it may have its limitations when applied in a corporate context and may raise problems of confidentiality, such as in questions concerning pending litigation to which the corporation will not be able to respond. Some of those responding in the SEC’s recent corporate governance hearings offered a variety of suggestions, such as the Levi Strauss proposal that shareholder proposals be permitted to require management to discuss certain areas of general interest to shareholders and the AT&T proposal requiring summaries of shareholder communications and company responses in the company’s annual report, subject to certain management discretion. See SEC Staff Summary, supra note 2, ¶ 81,653, at 80,640. Some corporations are moving toward several “informal” shareholders’ meeting on a regional basis, where more shareholders will have an opportunity to engage in a dialogue with management. See N.Y. Times, April 9, 1978, § 3, at 1, col. 1.

139. Such an approach might require limitation on the ability of shareholders to introduce proposals at the annual meeting. Such a limitation might take the form of a by-law amendment restricting shareholder proposals at the meeting to those which had appeared in the proxy statement.
management directors. Potential candidates need not be limited to the most senior executives of corporations. As indicated above, it is more important that the individuals selected have the appropriate traits of character, maturity, and experience, as well as a commitment to make the process work in the long-term interests of the private enterprise system.

140. Perhaps attempts should be made to develop a publicly available list as to potential available directors based on proxy statement filings with the SEC identifying the remuneration paid to senior officers of companies making filings under the Securities Exchange Act of 1934. Note that under recent SEC revisions in proxy statement regulations, the identity of such senior management officers for which disclosure must be made has been expanded in number. See SEC Securities Exchange Act Release No. 15380, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,765, and 4 Fed. Sec. L. Rep. (CCH) ¶ 70,962, Regulation S-K, Item 4 (a) (1978). Such a list need not be confined to business executives, but might include others (such as educators active in the business administration field, retired partners in accounting and law firms, and retired business executives) whose past experience might make them logical nominees as directors. This is not to suggest that recent efforts by the business community to broaden the background of board members should be abandoned. What is suggested is a conscious effort to identify in some organized fashion potential candidates for board membership. See, in this connection, N.Y. Times, Feb. 25, 1979, § F, at 3, col. 1.